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STATE CHOICE OF LAW RULES IN BANKRUPTCY

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I. Introduction

Following the enactment of the Bankruptcy Reform Act of 1978 (the "Code"),¹ the United States bankruptcy system experienced a number of growing pains. The Code ushered in a new way of looking at the entire bankruptcy process. As a result, Congress, courts and bankruptcy practitioners have spent the last ten years trying to convert the language of the Code into a workable bankruptcy system.

This conversion is nearly complete. Most major problems associated with the new Code have been resolved. For example, Congress and the courts have finally reached a solution to the jurisdictional problems laid bare in the Supreme Court's *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*² decision. Further, the United States Supreme Court recently resolved a dispute concerning the fundamental scope of adequate protection.³ As the Court resolves these issues, the lower court decisions have begun to exhibit a reasonable degree of consistency.

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1. Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended at 11 U.S.C. §§ 101-1329 (1982 & Supp. 1986)) (effective October 1, 1979). The 1978 Code has been altered by several amendments. The 1978 Code and all amendments will be collectively referred to as the "Code." Unless otherwise indicated, all statutory sections cited in this article will be sections of the Code.

2. 458 U.S. 50 (1982). Based on the vast amount of literature and litigation generated by *Northern Pipeline*, it is assumed that the reader has a working knowledge of that case and its major implications. For the uninitiated, a good introduction can be found in 1 COLLIER ON BANKRUPTCY ¶ 3.01, at 3-6 to 3-14 (L. King 15th ed. 1988).

3. In *United Sav. Ass'n v. Timbers of Inwood Forest Assoc., Ltd.*, 108 S. Ct. 626 (1988), the Court rejected the creditor's contention that 11 U.S.C. § 362(d)(1) (1982 & Supp. IV 1986), was intended to compensate secured creditors for the delay in realizing on their collateral.

Nevertheless, several important disputes remain. Although the courts have resolved many issues of interpretation, they have been far less successful in resolving a number of more fundamental issues involving the exact nature of bankruptcy. The process of adopting and implementing the Code has forced Congress and the courts to reconsider these fundamental issues from several differing perspectives.

One fundamental issue which remains unresolved is the respective roles of state and federal governments in bankruptcy. By revising both the substantive law and the procedural elements of the bankruptcy system, the Code has had a tremendous impact on this federal/state relationship. A number of recent articles have generated a lively debate on this topic.⁴ At the risk of oversimplification, the basic issue discussed in these works is whether Congress and the federal courts may—or should—alter state-created rights in the process of granting bankruptcy relief. Of course, the very notion of bankruptcy relief includes some modification of state law rights. The most obvious example is discharge, in which state law rights are literally erased.⁵ The Code, however, contains a number of other situations which give courts the power to modify or set aside some state law rights in the course of bankruptcy proceedings. The courts and commentators hold widely divergent views concerning the extent to which Congress and the federal courts should create a bankruptcy system in which the state law rights of parties differ in a bankruptcy court than in a state court.

The literature has typically portrayed the issue as a choice between federal and state law. In other words, the focus has been on isolating those instances in which a bankruptcy judge should use federal law to supersede or modify state law rights. In many cases, however, a related concern arises. There is no unified body of “state law.” The United States is comprised of fifty states, the District of Columbia and several territories. The substantive state laws⁶

4. Compare Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775 (1987) with Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815 (1987). See also Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857 (1982) [hereinafter cited as *Creditors' Bargain*]; Jackson, *Translating Assets and Liabilities to the Bankruptcy Forum*, XIV J. LEGAL STUD. 73 (1985) [hereinafter cited as *Translating Assets*]; Eisenberg, *Bankruptcy Law in Perspective*, 28 UCLA L. REV. 953 (1981).

5. See 11 U.S.C. § 727(b) (1982).

6. As used in this article, the term “substantive laws” denotes those rules that would be deemed rules of “substance” for state choice of law purposes. Although this definition is admittedly vague, it is clear that the class of substantive laws under the definition is significantly narrower than matters that would be deemed “substantive” for the purposes of applying the doctrine of *Erie R.R. Co. v. Tompkins*, 304 U.S. 64 (1938). Drawing a clear line between rules of substance and rules of procedure is a task that has been attempted by many authors. See, e.g., Westen & Lehman, *Is There Life for Erie After the Death of Diversity?*, 78 MICH. L. REV. 311, 360-64 (1980); Tunks, *Categorization and Federalism: “Substance” and “Procedure” After Erie Railroad v. Tompkins*, 34 ILL. L. REV. 271 (1939). Perhaps the most convenient definition is that offered in Redish & Phillips, *Erie and the Rules of Decision Act: In Search of the Appropriate Dilemma*, 91 HARV. L. REV. 356 (1977). The Redish & Phillips article sets out four categories of rules:

- (1) rules designed to provide behavioral guides or to attain state policy goals;
- (2) rules designed for the conduct of litigation that favor either plaintiffs or

defining the rights of the parties to a given transaction or event will rarely, if ever, be identical in each of these fora. Therefore, a bankruptcy court⁷ must do more than decide whether federal or state law⁸ will decide the rights of parties in a bankruptcy proceeding. Once a bankruptcy court decides that a right is governed by state law, it must decide which state's law is applicable. The answer to this second question may have a substantial impact on the rights of the parties.

The issue of which state's law will govern a transaction is related to, but distinct from, the federalism issues discussed in current literature. However, the choice of law question explored in this article also presents federalism

defendants;

(3) rules that are designed to ascertain the truth, which are neutral between the litigants; and

(4) housekeeping rules.

Id. at 394-95. The first two categories constitute "substantive" rules while the latter are "procedural." This definition is more useful than the others because it focuses on the purpose behind the rule instead of the impact that the rule might have on the outcome of the litigation.

7. This article will use "Bankruptcy Courts" to denote the court system created by the Code. The noncapitalized term "bankruptcy court" will be used to refer to any federal court hearing a claim in or related to a bankruptcy proceeding. As such, the "bankruptcy courts" include both the Bankruptcy Courts and the federal district courts hearing bankruptcy related claims either as a court of first impression pursuant to 28 U.S.C. § 1334 (1982), or on appeal from the Bankruptcy Courts under 28 U.S.C. § 158 (1982 & Supp. IV 1986). The term "bankruptcy court" does not include the federal district courts in lawsuits where the subject matter jurisdiction of the court is derived from a source other than 28 U.S.C. § 1334 (1982). Therefore, it will be important to distinguish bankruptcy cases from general federal question cases. In addition, the definition of bankruptcy courts excludes state or territorial courts, even when those courts are hearing a bankruptcy-related claim following abstention by the bankruptcy court under 11 U.S.C. § 305 (1982) or 28 U.S.C. § 1334 (1982).

For the purposes of this article, the differences between the Bankruptcy Courts and the district courts hearing bankruptcy matters are largely irrelevant. Although the subject matter jurisdiction of the Bankruptcy Courts is somewhat narrower than that of the district courts in bankruptcy (*compare* 28 U.S.C. § 157 (1982) (Bankruptcy Courts) *with* 28 U.S.C. § 1334 (1982) (district courts)), this difference does not affect the choice of law issue. This article will assume for the sake of convenience that the bankruptcy court adjudicating the dispute has subject matter jurisdiction over the claim.

The following discussion will also contrast the bankruptcy courts with the federal district courts sitting in diversity. For the sake of convenience, the term "diversity court" will be used to signify a federal court hearing a case in which jurisdiction is derived solely from 28 U.S.C. § 1332 (1982). Therefore, a court hearing a federal question, or a state law claim as ancillary or pendent to a federal question, is not a diversity court.

8. As used herein, the term "state law" denotes the statutory and common law of the states, the District of Columbia, and the territories. It excludes, however, all *federal* law - even that which is not bankruptcy-related. A bankruptcy court deciding issues of nonbankruptcy federal law does not face the same federalism concerns that are present when the bankruptcy court adjudicates state law. Furthermore, because the federal courts are a single system, choice of law questions do not often arise with respect to "which" federal law applies. Nevertheless, conflicts can and do arise between the application of state law and federal nonbankruptcy law. *See, e.g., In re L.M.S. Assocs., Inc.*, 18 Bankr. 425 (Bankr. S.D. Fla. 1982); *In re Altair Airlines, Inc.*, 727 F.2d 88 (3d Cir. 1984). These conflicts raise additional federalism issues that lie outside the scope of this article.

issues. In addition to a body of substantive law, every state has developed its own set of choice of law rules to guide its courts in deciding whether to apply that state's substantive law to a given transaction.⁹ The choice of law rules adopted by a state play a major role in defining the rights of litigants in that state. Therefore, the same concerns that oblige a bankruptcy court to adopt state substantive law might also oblige the court to take the additional step of using state choice of law rules in selecting a particular state's substantive law.¹⁰

The purpose of this article is to determine whether the bankruptcy courts are bound to use state choice of law rules when adjudicating state law rights in bankruptcy proceedings. The Code itself affords no guidance on this issue. The Supreme Court's decision in *Klaxon Co. v. Stentor Electric Manufacturing Co.*,¹¹ however, indicates that the federal courts, in certain cases, are required to adopt the choice of law rules of the forum state. The *Klaxon* rule is based upon several principles, not all of which necessarily apply in bankruptcy proceedings.¹² At the very least, the *Klaxon* rule represents an application of the Rules of Decision Act.¹³ Therefore, although the *Klaxon* rule is sometimes construed as applying only in diversity cases, the rule may also apply in bankruptcy to the extent that the principles underlying *Klaxon* apply in bankruptcy.

The conclusion of this article is that not all elements of the *Klaxon* rule apply in bankruptcy. Although a bankruptcy court adjudicating state law rights must refer to state choice of law rules, a bankruptcy court—unlike a diversity court—is not bound by forum choice of law rules. Instead, a bankruptcy court has considerable discretion, within certain limits, to select which state's forum choice of law rules to apply.

This article discusses the manner in which a bankruptcy court should apply state choice of law rules in adjudicating state law rights. Although a bankruptcy court is not bound by a state's forum choice of law rules, the ultimate resolution of the forum choice of law issue in bankruptcy should mirror the result a nonbankruptcy court would reach. As a result, the bankruptcy court does not have unfettered discretion on this matter when adjudicating state law rights. A bankruptcy court must select the choice of law rules of a state whose courts could have heard the dispute outside of

9. For a general overview of various choice of law methodologies, see B. CURRIE, *SELECTED ESSAYS ON THE CONFLICT OF LAWS* (1963); R. WEINTRAUB, *COMMENTARY ON THE CONFLICT OF LAWS* (3d ed. 1986).

10. Of course, in many situations there will be no difference between using state conflicts rules and "general" conflicts rules. For example, in actions involving disputed interests in real property, it would be quite unusual for a court to determine the ownership of the property using a substantive law other than the law of the forum where the property is situated. See *infra* text accompanying notes 37-39.

11. *Klaxon Co. v. Stentor Electric Mfg. Co.*, 313 U.S. 487 (1941). The *Klaxon* case is discussed in greater depth *infra* at notes 100-07 and accompanying text.

12. The principles underlying the *Klaxon* rule are discussed *infra* at text accompanying notes 108-28.

13. 28 U.S.C. § 1652 (1982).

bankruptcy. This restriction ensures that a bankruptcy court will adjudicate the parties' state law rights in accordance with the parties' reasonable expectations. In so doing, a bankruptcy court acts in accordance with the principles justifying the court's existence.

II. *State Law in Bankruptcy*

A. *Bankruptcy as a Procedural Device*

A discussion of choice of law rules applicable in bankruptcy requires an understanding of the fundamental nature of bankruptcy. Bankruptcy is best conceptualized as a federal procedure for the adjudication of all claims and interests affecting the estate of a single debtor.¹⁴ In most cases, the property rights of the parties involved in a bankruptcy proceeding are determined in accordance with state law.¹⁵ In essence, then, the bankruptcy laws are a framework for the efficient adjudication of nonbankruptcy rights. Absent some overriding federal policy, a bankruptcy court's interpretation of rights originating in state law should mirror a state court's interpretation of such rights as closely as possible. If the result in bankruptcy is significantly different, it will frustrate the reasonable commercial expectations of the parties to a transaction, and possibly create incentives or disincentives, unrelated to insolvency, for the use of bankruptcy.¹⁶ In addition, a bankruptcy court, by reaching a different result, steps out of its role as a "convenient single forum" for hearing state claims, and into a new, more active role. Congress did not intend the bankruptcy courts to play this more active role absent some bankruptcy-related reason to do so.

B. *A Point of Reference: the Nature of State Rights Presented in a Bankruptcy Proceeding*

Bankruptcy, then, is primarily a federal procedure for the adjudication of various rights and remedies created for the most part by state law. Before discussing the various ways in which state law is relevant in bankruptcy, it is necessary to establish, as a point of reference, the nature of the rights presented to the bankruptcy court for adjudication. In other words, state choice of law rules become a consideration only when the proceeding before a bankruptcy court involves the adjudication of state law rights. If the

14. H. REP. NO. 595, 95th Cong., 1st Sess. 10 (1977). See also *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156, 171 (1946) (Frankfurter, J., concurring), *reh'g denied*, 329 U.S. 833 (1946); 2 G. GILMORE, *SECURITY INTERESTS IN PERSONAL PROPERTY* § 45.2 (1965); *Translating Assets*, *supra* note 4, at 74-75; Hill, *The Erie Doctrine in Bankruptcy*, 66 HARV. L. REV. 1013, 1035 (1953).

15. *Butner v. United States*, 440 U.S. 48, 49 (1979); *Segal v. Rochelle*, 382 U.S. 375 (1966); *Commissioner v. Stern*, 357 U.S. 39 (1958); *Jaffke v. Dunham*, 352 U.S. 280 (1957); *Thompson v. Magnolia Petroleum Co.*, 309 U.S. 478 (1940); *In re Madeline Marie Nursing Homes*, 694 F.2d 433 (6th Cir. 1982). Of course, state law is not the only possibility. In some cases, the rights may be determined in accordance with the laws of foreign countries.

16. See, e.g., *Eisenberg*, *supra* note 4, at 958; *Baird*, *supra* note 4, at 824-28.

rights involved are purely federal, there is no reason to require a bankruptcy court to use state choice of law rules.

A bankruptcy court, however, usually will not have the opportunity to analyze each state right held by a party to a bankruptcy proceeding. Instead, it will adjudicate a given state law right only if that right is presented to the court in the context of some cognizable claim for relief. From a procedural standpoint, bankruptcy courts adjudicate claims which are simply an amalgam of various rights. Before a set of rights can be called a "claim," however, one must determine whether some body of law recognizes a claim in the given circumstances. The body of law that gives life to a set of rights as a claim may be state law or federal law.

The choice of law analysis, however, should not focus exclusively on whether the claim arises under state or federal law. In bankruptcy, it is misleading to focus only on the source of the claim. Most of the "claims" faced by a bankruptcy court arise under the Code. It is the Code that defines the posture in which a party presents a dispute to the bankruptcy court.¹⁷ Instead of viewing a claim as the fundamental unit, a bankruptcy court should dissect the claim into its component rights. The "nature" of a claim is ascertained solely by determining the nature of the rights that

17. For example, imagine a dispute in a bankruptcy case involving the amount that the debtor owes to a creditor because of a breach of contract. The substantive rights involved arise under state law. Nevertheless, in bankruptcy the dispute would arise as part of a federal claim. In all likelihood, the bankruptcy court would hear the claim because the trustee or some other party in interest objected to the proof of claim filed by the creditor.

The right to object to the proof of claim - *i.e.*, the right to bring the proceeding - arises under federal law and, therefore, is technically a federal "claim." In this situation, the court should apply bankruptcy law to determine the few "federal" elements of this claim, such as whether the proof of claim satisfies the requirements of the Bankruptcy Rules. The basic relationship between the parties, however, is originally defined by state law. State law should accordingly be used to resolve this element of the proceeding. By focusing on the source of the "claim," the bankruptcy court may make the mistake of applying federal law to matters that should be governed by state law.

This is not to say, however, that the source of the claim is in no way relevant to the choice of law question. Unlike the example given above, there are instances in which the Code creates *substantive* federal rights from the existing web of state law relationships. The preference provisions of the Code (primarily 11 U.S.C. § 547 (1982 & Supp. IV 1986)) are a good example of this. The federal substantive right created by section 547 comes into being if certain conditions are met. These conditions, however, are defined in part by the existing web of rights existing as of the date of bankruptcy. For example, under section 547(e), the court must determine whether the creditor's interest would take priority over other enumerated creditors. This subissue involves the adjudication of existing *state law* rights. Therefore, a claim to set aside a preference will involve the interpretation of "rights" arising under both federal and state law. See *supra* text accompanying notes 29-33.

Although the bankruptcy court should use state law to interpret state law rights irrespective of whether those rights are presented to the court in the course of a federal "claim," the source of the claim may have some bearing on the separate but distinct choice of law question. In other words, the degree to which the bankruptcy court is obligated to use state conflicts rules in *selecting* which law to apply may be different in the case of a federal claim than it is in the case of a state law claim. This issue is discussed *infra* at text accompanying notes 178-81.

must be adjudicated in order to resolve that claim. Accordingly, a claim is purely a state claim only if all of the rights that must be determined are state law rights. Conversely, a pure federal claim is one in which all the rights exist independent of state law.

Admittedly, this focus on "rights" differs somewhat from the traditional approach to the choice of law question in federal courts. The traditional approach typically focuses on whether the case before the court involves a state law "claim" or "issue."¹⁸ The terms "claim" and "issue," however, are not particularly relevant when assessing a proceeding before a bankruptcy court.¹⁹ The true nature of a claim or issue can be determined only by subdividing it into its component rights.

C. *How State Law Arises in Bankruptcy*

A bankruptcy case commences with the filing of a petition.²⁰ At that moment, a debtor steps into bankruptcy as the center of a web of financial relationships. This web, however, is generally created and defined by state law. The first duty of a bankruptcy court is to ascertain the exact contours of these state law rights. A bankruptcy court must determine what claims by and against the debtor exist before it can determine how those claims will fare in bankruptcy.

Because state law creates most of the rights that make up the web, state law will normally be the primary point of reference in interpreting the web.²¹ When determining the nonbankruptcy rights of parties involved in a bankruptcy proceeding, a bankruptcy court is essentially divining the rules of state law to adjudicate state law rights. Although federal law dictates which rights are recognized in the bankruptcy proceeding, it does not replace state law as the source of those rights. In this respect, bankruptcy courts are more closely related to diversity courts than to federal courts sitting in federal question cases.²²

18. See, e.g., *DelCostello v. International Bhd. of Teamsters*, 462 U.S. 151 (1983); *Maternally Yours, Inc. v. Your Maternity Shop, Inc.*, 234 F.2d 538, 540 n.1 (2d Cir. 1956) (*Erie* applies "to any issue or claim which has its source in state law").

19. The problems arising from using "claims" as the focal point are discussed *supra* at text accompanying notes 17-18. The term "issues" is of little use primarily because it is ambiguous. If one is speaking of purely factual issues, the term is useless from an *Erie* perspective. The basic facts underlying a dispute do not "arise" under either federal or state law. The court does not have to look to any body of law to determine, for example, if the building leased by the claimant has a leaky roof.

Confining one's analysis to "legal" issues is similarly misleading, because that term is tautological in the context of choice of law analysis; an issue is a "federal" issue only if it is to be decided under federal law. This cannot be determined by merely focusing on the issue itself. Instead, the court also needs to know the context in which the issue arises; namely, the underlying facts and the source of the primary right being adjudicated. These factors have a greater impact on the choice of governing law than the bare legal issue itself.

20. 11 U.S.C. § 301 (1982). The petition can be filed voluntarily by the debtor or an involuntary petition filed by one or more creditors. The additional requirements for an involuntary petition are set out in 11 U.S.C. § 303 (1982 & Supp. IV 1986).

21. See authority cited *supra* in note 14.

22. There are several different categories of federal question jurisdiction. "General" federal

This characterization, however, overlooks other important roles played by a bankruptcy court. Although state law defines the parties who are in financial relationships with the debtor prior to the bankruptcy petition, the Code may alter the rights of some of the parties or create new rights from the same underlying facts. A bankruptcy court may also be called upon to determine rights that would not arise had the parties been confined to their state law remedies. Because these new rights arise under a federal statute, they cannot be classified as state law rights.

The matter is further complicated by the fact that few disputes placed before a bankruptcy court involve solely state law or federal law rights. Instead, most claims presented to a bankruptcy court involve some mixture of the two types of rights. For purposes of convenience, claims that arise in bankruptcy can be pigeonholed into four classes: pure federal claims, pure state claims, mixed state claims and bankruptcy remedies.

1. Pure Federal Claims

In the course of a case arising under the Code, a considerable number of procedural issues may arise concerning the manner in which the bankruptcy system must deal with the various claims of debtors, their creditors and third parties. These procedural issues generally can be resolved simply by interpreting the language of the Code. For example, a motion by a creditor objecting to the qualifications of a court-appointed trustee involves issues that relate solely to federal bankruptcy law.²³ State law plays no part in the dispute. Because a bankruptcy court need look no further than the Code, choice of law issues do not arise. These purely federal matters are beyond the scope of this article.

2. Pure State Claims and Mixed State Claims

Most of the claims arising in bankruptcy, however, cannot be resolved simply by reading the Code. A bankruptcy court resolves numerous claims involving primarily state law rights. In some situations, a state claim takes a form virtually identical to the form it would take if prosecuted in state court. In other situations, the state law rights acquire a federal flavor by being transplanted into bankruptcy. Therefore, claims arising primarily under state law can be classified into two broad categories.

question jurisdiction is governed by 28 U.S.C. § 1331 (1982). In addition, there are various types of "special" federal question jurisdiction, *e.g.*, admiralty (28 U.S.C. § 1333 (1982 & Supp. IV 1986)), patent (28 U.S.C. § 1338 (1982)) and civil rights (28 U.S.C. § 1343 (1982)) cases.

23. Sections 321 and 322 set out the eligibility and qualification requirements for the trustee in bankruptcy. Other examples of purely federal rights are as follows: (a) the effect of the automatic stay provided by section 362 (although the exceptions to and grounds for relief from the stay do incorporate state law); (b) the duties of the debtor following commencement of a bankruptcy case (section 521); and (c) the grounds for converting a case from one chapter to another (sections 706, 1112, 1208, 1307).

The first category, the "pure" state claims, includes claims that are comprised almost entirely of state law rights. For example, a bankruptcy court liquidating the estate of a debtor must determine what assets comprise the estate and what liabilities are a charge against the estate. In determining the existence and value of these assets and liabilities, a bankruptcy court will be predominantly concerned with the underlying state law rights.²⁴ Although there are federal rights involved in the resolution of such claims, they are minimal when compared to the important state law issues.²⁵

The second category of state law claims, the "mixed" claims, is comprised of claims whose outcome may be affected by the Code. Various provisions of the Code modify existing state law rights in the process of transplanting the rights into bankruptcy. For example, the Code recognizes a creditor's right to set off any amounts that the debtor owes to the creditor against any payment that the creditor makes to the debtor.²⁶ In dealing with a setoff issue, a bankruptcy court must first look to state law to determine whether a right to setoff exists. Even assuming that such a state right exists, however, the Code places strict limitations on the use of setoff in bankruptcy cases.²⁷ Although state law is the "source" of the right to setoff, this right is modified once the debtor enters bankruptcy.²⁸ Thus, a bankruptcy court

24. The determination of whether an asset or liability exists must be differentiated from the determination of whether that asset forms a part of the debtor's estate or whether the creditor holding the claim will be allowed to participate in the bankruptcy liquidation. These latter issues involve both federal and state law rights. See *infra* note 28.

25. In every bankruptcy case involving a trustee, the right of the trustee to recover on a claim of the debtor is itself a "federal" right. See *supra* note 17.

26. 11 U.S.C. § 553 (1982 & Supp. IV 1986).

27. These restrictions are set out in section 553.

28. Sections 502 and 541 give rise to analogous situations. Under section 502, the bankruptcy court must determine which of the various claims of the creditors will participate in the bankruptcy case. Although the court looks to section 502 (and to the definition of a "claim" in section 101(4)) to determine which claims are included, it must look *ab initio* to state law to determine whether the creditor has a claim. *In re Elcona Homes Corp.*, 863 F.2d 483 (7th Cir. 1988); *In re John Clay & Co.*, 43 Bankr. 797, 807 (Bankr. D. Utah 1984). *Cf.* *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156, 159 (1946), *reh'g denied*, 329 U.S. 833 (1946); *Heiser v. Woodruff*, 327 U.S. 726, 732 (1946), *reh'g denied*, 328 U.S. 879 (1946). *But see* *Grady v. A.H. Robins Co.*, 839 F.2d 198, 203 (4th Cir. 1988) (even if claim not currently cognizable at state law, may participate in bankruptcy), *cert. dismissed*, 109 S. Ct. 201 (1988).

Similarly, under section 541, the court must look first to state law and determine the scope of the debtor's interest in property before it can reach the issue of whether that interest becomes property of the estate. One of the interesting aspects of section 541 is that it reduces the extent to which state law controls the determination of what is property of the estate. Under the National Bankruptcy Act of 1898, 30 Stat. 544 (1898) [hereinafter the "Act"], *repealed by* Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549, the courts in bankruptcy cases focused on alienability as a key element in determining ownership of property. If a debtor's property interest was not alienable outside of bankruptcy, it would in most cases be excluded from the estate. See, e.g., *Segal v. Rochelle*, 382 U.S. 375, 379 (1966).

State exemption laws also could affect the property that passed to the trustee under the Act, because exempt property did not become property of the estate. National Bankruptcy Act of 1898, at § 6; *Lockwood v. Exchange Bank*, 190 U.S. 294, 299 (1903). Because the Act relied

must do more than resolve state law rights. It must also interpret important rights arising under a federal statute.²⁹

In cases in which a bankruptcy court faces a mixed claim, choice of law issues may arise with respect to the state law components of the claim. The additional federal elements involved in the claim make the choice of law question more difficult. Unlike the situation with a pure state claim, federal law does more than establish the procedure by which a claim is presented to the court. Federal law also modifies the claim. Therefore, one can make a colorable argument that the federal nature of the claim frees a bankruptcy court of any obligation it might otherwise have to apply state choice of law rules.

3. *Bankruptcy Remedies*

As discussed previously, a debtor's financial relationship with others prior to bankruptcy gives rise to certain state law rights. The Code, however, grafts additional rights and responsibilities to this existing network of state law relationships. Most of these additional rights and responsibilities do not exist at state law. For example, the Code gives a debtor the ability to avoid certain nonpossessory liens on exempt property.³⁰ As another example, the Code grants a bankruptcy trustee the right to set aside various transfers of a debtor's property that occurred prior to filing the petition.³¹ These rights,

upon state law to determine a debtor's exemptions, the definition of property of the estate could vary greatly from state to state.

Under the Code, these criteria are largely irrelevant. First, a debtor's interest in property passes to the trustee regardless of whether the debtor has a right under state law to alienate that interest. 11 U.S.C. § 541(c)(1) (1982 & Supp. IV 1986); H.R. REP. NO. 595, 95th Cong., 1st Sess. 368 (1977). The only exception to this rule is a debtor's interest as beneficiary under a spendthrift trust, which, if valid under state law, does not pass to the trustee. 11 U.S.C. § 541(c)(2) (1982 & Supp. IV 1986). In addition, property of the estate now includes both exempt and nonexempt property. H.R. REP. NO. 595, 95th Cong., 1st Sess. 368 (1977).

29. Another example of a mixed claim is one arising under section 544(b), where the trustee succeeds to any state law rights held by an existing unsecured creditor of the debtor. This section enables the trustee to avoid bulk transfers and fraudulent conveyances under state law. Section 544(b), however, modifies the state law remedy in two ways. First, it effects a change in the plaintiff, because it is the trustee, not the creditor, who asserts the right. Second, and more importantly, section 544(b) increases the scope of the state remedy. Under state law, only the creditor with the right to set aside the transfer benefits from avoidance of the transfer. Under section 544(b), the avoidance benefits the estate itself, thereby inuring to the benefit of virtually all of the unsecured creditors. See *Moore v. Bay*, 284 U.S. 4 (1931); Note, *Applicability of State Conflicts Rules When Issues of State Law Arise in Federal Question Cases*, 68 HARV. L. REV. 1212, 1220 (1955). Therefore, transplanting the state law right into the bankruptcy forum alters its parameters. As a result, the trustee's rights under section 544(b) depend on both federal and state law.

30. 11 U.S.C. § 522(f) (1982).

31. See, e.g., 11 U.S.C. §§ 544(a), 548 (1982 & Supp. IV 1986). Under section 544(a), the trustee may avoid any lien that would be junior to a judgment lien creditor who took its interest as of the date of bankruptcy. Section 548, the "federal" fraudulent conveyance provision, is discussed *infra* at note 32.

although arising out of the web of state law rights existing on the date of bankruptcy, generally differ from the rights existing under state law.³²

This is not to say that state law is irrelevant. Although bankruptcy law gives rise to the basic dispute, the dispute cannot be resolved without reference to state law. The various remedies that the Code creates in favor of a trustee and other parties only exist if certain conditions are satisfied. To determine whether these conditions exist, however, a bankruptcy court must ascertain whether certain state law rights are present.³³ Therefore, although the proceeding involves a federal substantive right, a bankruptcy court must also resolve subsidiary state law rights. As discussed previously, a bankruptcy court should use state law in evaluating these subsidiary state law rights.³⁴ As in the situation of state mixed claims, however, the federal

32. Another example of a bankruptcy remedy is a preference, which is governed by section 547. Preferences are often considered to be a remedy unique to bankruptcy. Some states, however, have passed statutes condemning preferential transfers by an insolvent party. These statutes are generally limited to transfers made by a corporation anticipating liquidation. Countryman, *The Use of State Law in Bankruptcy Cases (Part II)*, 47 N.Y.U. L. Rev. 631, 632 (1972).

The bankruptcy remedy perhaps most similar to the existing state law rights is the "federal" fraudulent conveyance remedy set out at section 548. 11 U.S.C. § 548 (1982 & Supp. IV 1986). Depending on the state's fraudulent conveyance rules, section 548 may afford the trustee few, if any, rights that would not be available to the trustee as successor to the state law creditors under section 544(b). Nevertheless, even in those situations where the state fraudulent conveyance law closely parallels the provisions of section 548, the federal remedy affords the trustee an important advantage over the state law remedy. Under section 544(b), the trustee must identify an actual unsecured creditor who would have the right to attack the transaction under state fraudulent conveyance law. Because state fraudulent conveyance law is often available only to creditors who exist at the time of the conveyance (*see, e.g.*, Uniform Fraudulent Conveyance Act § 7) the lack of such a creditor may render a transfer immune from attack under section 544(b). Section 548, however, allows the trustee to avoid the transfer regardless of the existence of an actual creditor. Accordingly, the federal provision may create rights where none existed at state law.

33. For example, the trustee may only set aside an allegedly preferential transfer if it occurs within a specified period prior to bankruptcy. 11 U.S.C. § 547(b)(4) (1982 & Supp. IV 1986). To resolve this timing issue, the court must determine when the transfer occurred. Although section 547(e) specifies when the transfer is made, it incorporates the governing state law rules, *inter alia*, the attachment and perfection of security interests.

State law issues can also arise in other contexts of preference law. *Miller v. Wells Fargo Bank*, 406 F. Supp. 452 (S.D.N.Y. 1975) (pre-Code decision), *aff'd*, 540 F.2d 548 (2d Cir. 1976). In *Miller*, the trustee was attempting to recover two payments that the debtor had made pursuant to a loan from the creditor to the debtor. In order to decide the preference question, the court had to determine whether the creditor was secured by an interest in various funds that the debtor had deposited in the creditor bank. This required the court to look at state law governing assignments of contractual rights.

As discussed *supra* at note 32, another example of a "hybrid" action is a proceeding to recover a fraudulent conveyance under section 548. Section 548, like section 547, also depends upon state law for certain crucial definitions. *See, e.g.*, 11 U.S.C. § 548(d)(1) (1982 & Supp. IV 1986) (a "transfer" is deemed to have occurred for purposes of section 548 when a bona fide purchaser from the debtor cannot obtain an interest superior to that of the transferee).

34. The preceding discussion of the bankruptcy remedies has emphasized the trustee's avoidance powers. The bankruptcy remedies are not limited to claims arising under Subchapter III of Chapter 5. For example, section 365 provides the trustee with the power to assume or

nature of bankruptcy remedies create some uncertainty as to whether state law or federal law should be used in selecting which state's substantive law determines these underlying issues.

III. Choosing a State Law

When faced with a choice of law question, a bankruptcy court must look beyond the terms of the Code. The Code and its legislative history offer little guidance on the choice of law problem. Although the Code develops certain concepts in excruciating detail, it nowhere provides general rules to guide a bankruptcy court in its selection of the proper state law to adjudicate state law rights.³⁵ Therefore, a court must look to other sources for the methodology to be used in its selection of which state's substantive law to apply.

A. The Approach Taken By Bankruptcy Courts

A significant number of bankruptcy courts have faced the choice of law issue in the course of a bankruptcy proceeding.³⁶ Not all of these cases are

reject an executory contract. See 11 U.S.C. § 365 (1982 & Supp. IV 1986). Under section 365(b), the trustee must meet certain criteria if she wants to assume a contract under which the debtor is in default. The Code does not define, however, what constitutes a "default," although section 365(b)(2) does specify that certain types of defaults can be ignored. Because state law typically defines the obligations of the parties to the underlying contract, the court should look to state law to determine which omissions or commissions constitute a default.

Similarly, the question of whether a claim is dischargeable in bankruptcy may involve questions of both federal and state law. The court in *In re Crist*, 632 F.2d 1226 (5th Cir. 1980), cert. denied, 451 U.S. 986 (1981), was faced with the question of whether certain court-ordered payments that the debtor owed to his ex-spouse constituted alimony or a property settlement. If characterized as alimony, the obligation to make the payments would survive a discharge in bankruptcy under section 523(a)(5). 11 U.S.C. § 523(a)(5) (1982 & Supp. IV 1986). The court held that, although the definition of alimony was one of federal law, that definition depended upon the substantive rights of the parties under the governing state law. *In re Crist*, 632 F.2d at 1229.

The exemption provisions of the Code present a similar situation. Unless a state makes use of the Congressional authorization to override the federal exemptions, a debtor in a bankruptcy case may elect to use the list of exemptions enumerated in section 522(d) of the Code. 11 U.S.C. § 522(d) (1982 & Supp. IV 1986). Even if the debtor elects the federal exemptions, however, state law plays an important role. Although federal law enumerates those interests of the debtor which are exempt, it is state law that creates and gives form to the underlying interests.

35. In one specific instance, however, the Code does supply choice of law rules. See *infra* note 75.

36. Of course, in many multistate cases choice of law will not be an issue. For example, the parties may have agreed in their pleadings that a given forum's law will govern the dispute. See, e.g., *In re Duplan Corp.*, 455 F. Supp. 926 (S.D.N.Y. 1978). A different situation is presented by a choice of law clause in a contract. Even though the contracting parties have agreed that the law of a given forum will govern their obligations, the court may nevertheless be faced with a choice of law issue: whether to enforce the clause. Generally, a contractual choice of law clause will be enforced if the contract bears a reasonable relationship with the

relevant to the topic at hand. For instance, in many situations a court is faced with a "false conflict" where resolution of the choice of law issue does not affect the outcome of the proceeding. Questions involving interests in real property often create false conflicts. Under general conflicts principles, questions involving interests in real property will in all likelihood be determined by the law of the situs of the property.³⁷ Therefore, the outcome of a dispute involving interests in real property will be the same regardless of whether a bankruptcy court uses the forum state's conflict laws, some other state's conflict laws, or even "federal" conflicts law.³⁸ Because the same substantive law would be chosen regardless of the choice of law rules selected, a bankruptcy court need not face the more difficult federalism issues underlying the choice of law decision. Accordingly, cases involving false conflicts are not particularly helpful in resolving the choice of law problem.³⁹

Even after excluding the false conflict cases, however, a substantial number of cases remain. These cases are surprisingly consistent. Most courts that have determined an issue is governed by state law have also determined that the choice of state law should be achieved by using state choice of law rules.⁴⁰ Unfortunately, a review of the cases yields no uniform basis for this

chosen forum. *See, e.g.*, U.C.C. § 1-105(1) (1985).

When faced with a choice of law clause, the court must elect whether to determine "reasonableness" under a state or federal standard. If the court elects to use a state standard, it may also be required to select which state's standard to apply. The few bankruptcy courts that have faced this issue have elected to use a "federal" rule governing reasonableness of the forum selection clause. *See, e.g.*, *In re Falk*, 2 Bankr. 609 (Bankr. D.N.J. 1980); *Enviro-lite Ents. v. Glastechnische Indus.*, 53 Bankr. 1007 (S.D.N.Y. 1985), *aff'd*, 788 F.2d 5 (2d Cir. 1986); *In re Caldwell Port Elevator, Inc.*, 23 Bankr. 154 (Bankr. W.D. La. 1982).

37. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 223 (1971).

38. *In re Cochise College Park, Inc.*, 703 F.2d 1339, 1348 n.4 (9th Cir. 1983); *In re Engstrom*, 33 Bankr. 369 (Bankr. D.S.D. 1983); *In re Nite Lite Inns*, 13 Bankr. 900, 907 (Bankr. S.D. Cal. 1981). Thus, where all of the candidate choice of law rules would result in selection of the same substantive law, the method used in choosing a choice of law system is largely irrelevant.

Conversely, the underlying *substantive* law of all the candidate fora may be identical. Therefore, even though the selection of a set of choice of law rules may affect the decision of which state's substantive law is applied, the substantive law itself may be so similar as to result in the same ultimate outcome. For example, there are very few cases under the Uniform Commercial Code ("U.C.C.") involving genuine conflicts, primarily because the U.C.C. has been adopted in substantially similar form in all states except Louisiana. Hence, in many cases involving the U.C.C., it is irrelevant which law is selected by the court. *See, e.g.*, *In re Worden*, 63 Bankr. 721 (Bankr. D.S.D. 1986) (choice of law rules lead to same result); *In re Dennis Mitchell Indus., Inc.*, 419 F.2d 349 (3d Cir. 1969) (substantive law identical). *See also In re Merritt Dredging Co.*, 839 F.2d 203 (4th Cir. 1988), *cert. denied*, 108 S. Ct. 2904 (1989), discussed *infra* at note 43.

39. The adjudication of a party's interest in a trust comprised of tangible property presents many of the same considerations. Therefore, these cases may also present false conflicts. *See, e.g.*, *In re Torrez*, 63 Bankr. 751 (Bankr. 9th Cir. 1986), *aff'd*, 827 F.2d 1299 (9th Cir. 1987); *In re Landis*, 41 F.2d 700 (7th Cir. 1930), *cert. denied*, 282 U.S. 872 (1930); *Danning v. Lederer*, 232 F.2d 610 (7th Cir. 1956).

40. *See* cases cited *infra* at notes 38 & 39.

conclusion. Some courts elect to use state law without presenting any real basis for their decision.⁴¹ Most of the other courts have simply cited *Klaxon* as controlling.⁴² Only a few have explored the issue in any depth.⁴³ Even

41. *In re New England Fish Co.*, 749 F.2d 1277, 1280 (9th Cir. 1984) (negligence claim); *In re Bagley*, 6 Bankr. 387 (Bankr. N.D. Ga. 1980) (validity of repossession of a debtor's automobile); *In re Worden*, 63 Bankr. 721 (Bankr. D.S.D. 1986) (status of creditor's interest in accounts receivable); *In re Bennett*, 51 Bankr. 619 (Bankr. D.N.M. 1984) (fraud in connection with the procurement of a promissory note).

42. See, e.g., *Goldstein v. Madison Nat'l Bank*, 807 F.2d 1070 (D.C. Cir. 1986); *In re Auto-Train Corp.*, 9 Bankr. 159, 161 n.5 (Bankr. D.C. 1981); *In re Medico Assoc., Inc.*, 23 Bankr. 307, 315 (Bankr. D. Mass. 1982); *In re Shangri-La Nursing Center, Inc.*, 31 Bankr. 367 (Bankr. E.D.N.Y. 1983); *In re Shepard*, 29 Bankr. 928 (Bankr. M.D. Fla. 1983); *In re Sweetapple Plastics, Inc.*, 77 Bankr. 304 (Bankr. M.D. Ga. 1987); *In re Pester Ref. Co.*, 66 Bankr. 801 (Bankr. S.D. Iowa 1986), *aff'd*, 85 Bankr. 520 (S.D. Iowa 1987), *aff'd [rev'd] in part*, 845 F.2d 1476 (8th Cir. 1988); *In re Goldstein*, 66 Bankr. 909 (Bankr. W.D. Pa. 1986); *In re B & L Oil Co.*, 46 Bankr. 731 (D. Colo. 1985); *In re Eden Assocs.*, 13 Bankr. 578 (Bankr. S.D.N.Y. 1981); *In re Energy Research & Dev. Corp.*, 7 Bankr. 933 (Bankr. W.D. Wis. 1981); *In re Magnus Harmonica Corp.*, 159 F. Supp. 778 (D.N.J. 1958) (*Klaxon* applies to all state law issues except interest, which is governed by federal law), *aff'd*, 262 F.2d 515 (3d Cir. 1959).

But see *In re Knight*, 76 Bankr. 857 (Bankr. M.D. Ga. 1987); *In re Smith*, 66 Bankr. 58 (Bankr. D. Md. 1986), *aff'd*, 77 Bankr. 33 (D. Md. 1987), which hold that *Klaxon* is inapplicable in bankruptcy. See discussion of *Knight* *infra* at note 71.

43. The most insightful circuit court opinion is the Fourth Circuit's in *In re Merritt Dredging Co.*, 839 F.2d 203 (4th Cir. 1988), *cert. denied*, 108 S. Ct. 2904 (1989). The primary issue in *Merritt* was whether a certain agreement constituted a security agreement for purposes of bankruptcy. Because the agreement had significant connections with two states, the court had to choose which state's law to use in deciding whether the agreement was a security agreement. *Id.* at 205. After developing the arguments on both sides of the issue, the court concluded that *Klaxon* controlled the adjudication of the state law issues. *Id.* at 206. Although the court indicated that a compelling federal interest might lead to a different conclusion, it could find no compelling federal interest in the facts of the case.

The Ninth Circuit employed a similar rationale in *In re Holiday Airlines Corp.*, 620 F.2d 731 (9th Cir.), *cert. denied*, 449 U.S. 900 (1980). In *Holiday*, the court was faced with an issue similar to that in *Merritt*: the validity of artisan's lien on personal property. Unlike the situation in *Merritt*, however, a federal statute governed the issue. Because the property at issue was an airline component, the lien was governed by the Federal Aviation Act, 49 U.S.C. §§ 1301-1542 (1982). Section 1406 of the Federal Aviation Act specifies which state's law is to be used in determining the perfection of a state law lien in airplane components. The court held that, under these circumstances, *Klaxon* does not require the bankruptcy court to follow the choice of law rules of the forum. Because *Erie* is inapplicable where an Act of Congress controls, the choice of law issue was controlled by the federal act, not *Klaxon*. The court's decision implies, however, that *Klaxon* would control in the absence of the Federal Aviation Act. *Id.* at 734.

Several bankruptcy judges have also been troubled by the role of *Klaxon* in bankruptcy. Like the *Merritt* and *Holiday* opinions, several of the opinions have considered the validity or priority of liens held by creditors in property of the debtor. The courts are split on the issue of whether *Klaxon* controls. See, e.g., *In re LMS Assocs., Inc.*, 18 Bankr. 425 (Bankr. S.D. Fla. 1982) (substantive law of the forum applied to determine whether liens were perfected even though forum courts would have applied a different substantive law); *In re Flying W Airways, Inc.*, 341 F. Supp. 26 (E.D. Pa. 1972) (pre-Code case which applied *Klaxon* on issue of lien validity); *In re U.S. Repeating Arms Co.*, 67 Bankr. 990 (Bankr. D. Conn. 1986) (*Klaxon* applied on issue of whether creditor held a security interest). In addition, the applicability of *Klaxon* has been considered in cases dealing with tort claims (*Seitter v. Schoenfeld*,

the decisions that explore the issue are often unclear as to why *Klaxon* controls the result in bankruptcy. The discussions rarely explore the various considerations giving rise to the rule in *Klaxon*, and whether those considerations apply in bankruptcy. Without understanding these principles, a conclusion that *Klaxon* governs in bankruptcy begs the question. It is therefore necessary to retrace the development of the current rules governing state choice of law in the federal courts to discern those principles that should guide the bankruptcy courts in their decision.

B. *The Rules of Decision Act*

The starting point in a court's analysis must be the Rules of Decision Act (the "Decision Act").⁴⁴ Although the Code itself places no explicit limitations on the choice of law methodology to be used in a bankruptcy case, the bankruptcy courts, as federal courts, are bound by the provisions of the Judicial Code.⁴⁵ To the extent that a provision of the Judicial Code governs the choice of law issue in the federal district courts, it also dictates the result in a bankruptcy court. Of all the provisions in the Judicial Code, the one most likely to affect the choice of law issue is the Decision Act.⁴⁶

The Decision Act mentions neither choice of law rules nor bankruptcy. It is unclear, therefore, whether the Decision Act has any application whatsoever to the choice of law issue in bankruptcy. In order to resolve this issue, it is important to look in greater depth at the interpretation afforded the Decision Act by the United States Supreme Court. A review of the Supreme Court's interpretation reveals the full import of the Decision Act.

678 F. Supp. 831 (D. Kan. 1988) (*Klaxon* controls)), state law fraudulent conveyances (*In re OPM Leasing Servs., Inc.*, 28 Bankr. 740 (Bankr. S.D.N.Y. 1983) (since cause of action under section 544(b) is created by state law, *Klaxon* controls)), measurement of damages (*In re D.H. Overmeyer Co.*, 12 Bankr. 777 (Bankr. S.D.N.Y. 1981) (*Klaxon* controls), *aff'd*, 30 Bankr. 823 (S.D.N.Y. 1983)) and warranty claims (*In re Barney Schogel, Inc.*, 12 Bankr. 697 (Bankr. S.D.N.Y. 1981) (although *Klaxon* is not controlling, the bankruptcy court should normally apply forum choice of law rules in the absence of facts indicating otherwise)).

44. 28 U.S.C. § 1652 (1980). The Decision Act states: "The laws of the several states, except where the Constitution or treaties of the United States or Acts of Congress otherwise require or provide, shall be regarded as rules of decision in civil actions in the courts of the United States, in cases where they apply."

45. The Judicial Code is codified at title 28, of the United States Code. Section 151 of the Judicial Code establishes the Bankruptcy Courts as a separate body of federal courts. As discussed *supra* in note 7, the Judicial Code also sets forth the subject matter jurisdiction of the district courts and Bankruptcy Courts in bankruptcy.

46. The recent articles dealing with state law in bankruptcy have generally ignored the issue of whether the Decision Act and *Erie* are applicable in bankruptcy proceedings. With the exception of Countryman, *The Use of State Law in Bankruptcy Cases (Part I)*, 47 N.Y.U. L. Rev. 407, 409 (1972), which rejects *Erie* out of hand, authors have generally approached the issue of whether a bankruptcy court must follow state law without reference to this body of law. The reason for this omission is unclear to this author. Although it is admittedly open to debate whether the Decision Act and *Erie* apply in bankruptcy, this issue certainly warrants some discussion. Indeed, an earlier article dealing with the same federalism issues approached the problem from the perspective of *Erie*. See Hill, *supra* note 14.

1. *The Requirements of the Decision Act*

Originally enacted in 1789 as Section 34 of the Judiciary Act of 1789, the Decision Act addresses the law applied by the federal courts in civil actions.⁴⁷ In essence, the Decision Act sets forth a general directive to the federal courts to use state law as the "rule of decision" in civil litigation. If the Decision Act governs in a given lawsuit, the federal court must look to state law to adjudicate the primary rights of the parties.

The Decision Act, however, obviously does not apply to every lawsuit in federal court. A federal court is freed of the Decision Act's requirements if certain criteria are met. Therefore, the important issues that arise in the interpretation of the Decision Act are not limited to determining which state laws are "rules of decision." A court construing the Decision Act must also recognize those instances in which some federal concern frees the federal court from an obligation to apply state law. In the absence of this "federal ingredient," the court must use state law as the rule of decision. It is useful to focus narrowly upon those cases in which a sufficient federal ingredient was found, because they illustrate the various exceptions to the application of the Decision Act for federal courts.

Since *Erie Railroad Co. v. Tompkins*,⁴⁸ the courts have recognized several instances in which the federal courts are freed from state law in adjudicating a lawsuit.⁴⁹ These cases may be classified into three broad categories:

47. As originally enacted, the Decision Act applied only to proceedings "at common law." In 1948, however, the Act was amended to encompass "all civil actions." See 28 U.S.C. § 1652 (1982). This amendment supports the argument that the Decision Act is applicable in bankruptcy. See *infra* note 137.

48. 304 U.S. 64 (1938).

49. Most of the decisions that have considered the issue of state law in the federal courts have focused on the broader *Erie* doctrine instead of the Decision Act. This is not to say, however, that these decisions are not useful in interpreting the reach of the Decision Act. The differences between the commands of the Decision Act and the *Erie* doctrine are difficult to identify. The line of demarcation is particularly fuzzy because the Supreme Court, both before and after *Erie*, has stated that the Decision Act "is merely declarative of the rule which would exist in the absence of the statute." *Guaranty Trust Co. v. York*, 326 U.S. 99, 105 (1945); *Mason v. United States*, 260 U.S. 545, 559 (1923). The full import of this statement is unclear. The Court may be indicating that the Decision Act simply restates the requirements of the Constitution. Cf. P. BATOR, D. MELTZER, P. MISHKIN & D. SHAPIRO, *HART AND WECHSLER'S THE FEDERAL COURTS AND THE FEDERAL SYSTEM* 750 n.2 (1988) [hereinafter cited as *HART & WECHSLER*]. But cf. 2 W. CROSSKEY, *POLITICS AND THE CONSTITUTION IN THE HISTORY OF THE UNITED STATES* 870-74 (1953).

As discussed *infra* at text accompanying notes 108-11, the *Erie* doctrine is based in large part on the language of the Decision Act. The reach of *Erie*, however, probably exceeds that of the Decision Act. See, e.g., *Guaranty Trust Co. v. York*, 326 U.S. 99 (1945) (*Erie* extends to actions in equity even though the language of the Decision Act was then limited to "suits at common law"); *Tuxedo Contractors, Inc. v. Swindell-Dresser, Inc.*, 613 F.2d 1159 (D.C. Cir. 1979) (although Decision Act does not mandate the use of the law of the District of Columbia, a federal court sitting in diversity should use District of Columbia law as the rule of decision). Therefore, the federal courts may be required to use state law as the rule of decision even in areas not covered by the terms of the Decision Act. Because the *Erie* doctrine is somewhat broader, a holding that the federal court is not required under *Erie* to apply state

- (1) where a federal court is adjudicating a case in which the basic rights are created by a federal statute, treaty, or the Constitution;⁵⁰
- (2) where a federal court is adjudicating a case in which the basic rights are created by certain narrow categories of federal common law;⁵¹ and
- (3) where there is a federal interest that, although not giving rise to a cause of action, nevertheless removes the case from a literal application of the Decision Act.⁵²

The first category is justified by the language of the Decision Act itself. By its terms, the Decision Act does not apply if the Constitution or a federal treaty or statute provides otherwise. Accordingly, to the extent that a court is adjudicating basic rights arising under a federal statute, or interpreting the terms of that statute, it need not refer to state law.

The second category also follows, albeit more indirectly, from the Decision Act. Under the Decision Act, a court need only utilize state laws "in cases where they apply."⁵³ In other words, the federal court looks to state law only in those situations where the primary rights being adjudicated are rights created by state law. In certain narrow categories, however, federal courts have created pockets of federal common law. Generally, this federal common law applies in areas in which the Constitution grants the federal government virtually exclusive authority.⁵⁴ If the subject matter of the lawsuit is governed

law in a given case of necessity means that the Decision Act does not control that case. Therefore, cases refusing to apply state law under the *Erie* doctrine can be used as precedents under the Decision Act.

The converse is more difficult to argue. Merely because a court holds that a federal court is required to apply state law does not of necessity mean that the Decision Act is controlling. Before these cases can be used as precedent for the Decision Act, one must confirm that the case would fall under the language of the Act itself, and not in one of the areas in which *Erie* is broader than the Act. Given that the current wording of the Decision Act covers all civil actions, the cases falling within *Erie* but without the Decision Act are relatively few. *But cf.* *Tuxedo Contractors, Inc. v. Swindell-Dresser, Inc.*, 613 F.2d 1159 (D.C. Cir. 1979). Therefore, the majority of the cases in which state law was held to be controlling can be used as precedent for the applicability of the Decision Act.

50. *See, e.g.*, *DelCostello v. International Bhd. of Teamsters*, 462 U.S. 151, 159-61 (1983) (Decision Act does not require a federal court to borrow state statutes of limitation in adjudicating a federal statutory right); *Sola Elec. Co. v. Jefferson Elec. Co.*, 317 U.S. 173, 176 (1942) (federal court need not apply state rules of estoppel where state rules would detract from enforcement of the federal statutory right); *Southern Pac. Transp. Co. v. United States*, 462 F. Supp. 1193 (E.D. Cal. 1978).

51. *Moragne v. States Marine Lines, Inc.*, 398 U.S. 375 (1970) (federal common law controls in admiralty and maritime cases); *Hinderlider v. La Plata River & Cherry Creek Ditch Co.*, 304 U.S. 92 (1938) (case during the same term as *Erie*; apportionment of an interstate stream decided under federal common law), *reh'g denied*, 305 U.S. 668 (1938).

52. *See* *Banco Nacional de Cuba v. Sabbatino*, 376 U.S. 398 (1964); *Clearfield Trust Co. v. United States*, 318 U.S. 363 (1943); *Bank of America Trust & Sav. Ass'n v. Parnell*, 352 U.S. 29 (1956); *Byrd v. Blue Ridge Elec. Coop, Inc.*, 356 U.S. 525, *reh'g denied*, 357 U.S. 933 (1958).

53. 28 U.S.C. § 1652.

54. *See, e.g.*, *Moragne v. States Marine Lines, Inc.*, 398 U.S. 375 (1970) (federal law used

by federal common law, state law is preempted and therefore does not apply. A federal court in such a case will apply federal common law as fully as if the federal law were set out in the Constitution or an act of Congress.

The final category is not found in the language of the Decision Act. Instead, in areas of peculiarly great federal interest, courts have created an implied exception to the mandate of the Decision Act. This federal interest may arise in a variety of contexts. For example, it may appear in cases presenting issues of national or international concern.⁵⁵ In other cases, the dispute may directly affect the rights and obligations of the United States.⁵⁶ Further, the Decision Act may not apply where there is a strong need for uniformity in the outcome of a certain type of litigation.⁵⁷ Finally, there may be other federal interests involved in the process or in the result of a lawsuit that might be upset if a federal court was to use state law.⁵⁸ In these cases, federal law is applied as the "rule of decision," even though the primary rights involved in the litigation are rights created by state law. The court may elect to apply federal law if it fears that use of state law will lead to an undesirable or anomalous result.⁵⁹

2. Does the Decision Act Apply in Bankruptcy?

The Decision Act, then, does not apply in every lawsuit in the federal courts. In fact, a majority of cases construing the Decision Act have involved lawsuits brought to a federal court under its diversity jurisdiction.⁶⁰ Because of this emphasis on diversity, it has sometimes been stated that the Decision Act applies only in diversity cases.⁶¹ Accordingly, because bankruptcy courts

as the rule of decision in admiralty and maritime—areas almost exclusively within the purview of the federal government).

55. See, e.g., *Banco Nacional de Cuba v. Sabbatino*, 376 U.S. 398 (1964) (where outcome of litigation is likely to affect international relations federal law must be applied).

56. See, e.g., *Clearfield Trust Co. v. United States*, 318 U.S. 363 (1943) (federal common law applied to lawsuit by United States to recover proceeds of federal payroll check).

57. See, e.g., *Bank of America Trust & Sav. Ass'n v. Parnell*, 352 U.S. 29 (1956) (federal common law applied to determine due date of federal bonds, even though the United States was not a party and could not be bound by the outcome of the litigation).

58. *Byrd v. Blue Ridge Elec. Coop., Inc.*, 356 U.S. 525 (1958), *reh'g denied*, 357 U.S. 933 (1958), is probably the best known case in this category. In *Byrd*, the Court held that the federal interest in affording jury trials to litigants relieved the Court of the obligation to follow the state practice of reserving the issue for the bench, although the seventh amendment did not control under the particular facts.

59. See generally Mishkin, *The Variousness of "Federal Law": Competence and Discretion in the Choice of National and State Rules for Decision*, 105 U. PA. L. REV. 797, 799-801 (1957).

60. See, e.g., *Erie R.R. v. Tompkins*, 304 U.S. 64 (1938); *Guaranty Trust Co. of New York v. York*, 326 U.S. 99 (1945); *Hanna v. Plumer*, 380 U.S. 460 (1965); *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541 (1949). However, the Decision Act has also been construed in nondiversity cases. E.g., *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967).

61. See, e.g., Note, *Adopting State Law as the Federal Rule of Decision: A Proposed Test*, 43 U. CHI. L. REV. 823, 826 (1976).

do not rely on diversity of citizenship to acquire subject matter jurisdiction over a dispute, it is questionable whether the Decision Act has any real impact in bankruptcy.

Nevertheless, it is fairly clear that the Decision Act is not confined to diversity cases. The Decision Act on its face applies to all "civil actions"; making no distinction as to the source of federal jurisdiction. Even without specific authorization from the Supreme Court, lower federal courts have held that state law should control in cases in which a federal court adjudicates state law claims pendent or ancillary to claims involving a federal question.⁶² Like a bankruptcy court, a federal court hearing a claim under its ancillary or pendent jurisdiction is interpreting rights that arise under state law. Furthermore, a court can usually hear the claim without regard as to whether there is diversity of citizenship among the litigants.⁶³ These courts are correct in noting the question whether the Decision Act applies cannot be answered simply by classifying the case as a diversity or nondiversity case. Instead, one must also consider the source of the substantive rights adjudicated in the lawsuit.⁶⁴

62. *United Mine Workers v. Gibbs*, 383 U.S. 715, 728 (1966) (dictum); *Bi-Rite Enters., Inc. v. Bruce Miner Co.*, 757 F.2d 440, 442 (1st Cir. 1985); *Colgate Palmolive Co. v. S/S Dart Canada*, 724 F.2d 313, 316 (2d Cir. 1983), *cert. denied*, 466 U.S. 963 (1984); *System Operations, Inc. v. Scientific Games Devel. Corp.*, 555 F.2d 1131, 1136 (3d Cir. 1977); *Marathon Petroleum Co. v. LoBosco*, 623 F. Supp. 129, 134 (N.D. Ill. 1985); *Viens v. Anthony Co.*, 282 F. Supp. 983, 985 (D. Vt. 1968). *See also* *Taussig v. Wellington Fund, Inc.*, 313 F.2d 472 (3d Cir. 1963) (dictum), *cert. denied*, 374 U.S. 806 (1963). *See also* Annotation, *Modern Status of Rules as to Pendent Federal Jurisdiction over Nonfederal Claims*, 5 A.L.R. 3d 1040, 1060 (1966) (while this annotation has been superceded, none of the replacement annotations deal with the above issue). *Accord* *Westen & Lehman*, *supra* note 6, at 366-67.

None of the cases cited above rely exclusively upon the Decision Act as the basis for their holding. Each is instead based at least in part on the broader *Erie* doctrine. As discussed *supra* at note 49, however, this does not necessarily mean that the decisions are not of value in construing the scope of the Decision Act. Indeed, because the language of the Decision Act would appear to cover the situations presented in each of the above cases, the Decision Act alone would have constituted sufficient authority for the holding in each case.

63. In multiparty litigation presenting certain fact situations, lack of diversity between the litigants may serve to defeat the use of ancillary or pendent jurisdiction. In *Aldinger v. Howard*, 427 U.S. 1 (1976), the plaintiff attempted to join a federal question claim against one defendant with a state law claim against another, nondiverse defendant. The Supreme Court refused to allow the exercise of pendent jurisdiction, although it stated that such jurisdiction might be proper in exceptional circumstances.

Aldinger, however, applies only when a plaintiff's sole claim against a nondiverse defendant is a state law claim. When plaintiff alleges both a federal question claim and a related state law claim against the same defendant, lack of diversity between the plaintiff and defendant does not bar the exercise of jurisdiction over the state law claim. *See* *United Mine Workers v. Gibbs*, 383 U.S. 715 (1966). The analogous doctrine of ancillary jurisdiction has been applied to state law claims involving nondiverse parties set forth in counterclaims, cross-claims, and third party claims. *Cf. Owen Equipment & Erection Co. v. Kroger*, 437 U.S. 365 (1978).

64. As discussed *supra* in text accompanying notes 17 & 18, the proper focus in bankruptcy is on the source of the substantive rights being adjudicated in the lawsuit. One cannot simply focus on the source of the "claim" that gave rise to the proceeding. Although the right to bring the proceeding from the bankruptcy court may be created by the Code, the proceeding may involve primarily state law rights.

This conclusion is bolstered by several other federal court decisions which apply state law in federal question cases. For example, federal courts have applied state law as the rule of decision in interpreting state administrative agency orders in the context of a federal antitrust claim,⁶⁵ and in determining what defenses are available in an action arising under a federal consumer protection statute.⁶⁶ In such cases, the courts have held that state law must be applied in adjudicating all state law rights absent a contrary indication in the underlying federal statute.⁶⁷

This is not tantamount to saying that the Decision Act requires the application of state law in all federal court litigation. A nondiversity case will more likely invoke one of the previously described categories of exceptions to the Decision Act. For example, in litigation between two states, a state and a citizen of a different state, or a state and a subdivision of that state, the Supreme Court has indicated that state law may not apply.⁶⁸ Alternatively, as previously discussed,⁶⁹ the case may involve uniquely federal interests that remove it from the mandate of the Decision Act. It is not lack of diversity alone, however, which removes these cases from the reach of the Decision Act. Instead, each of the cases involves one of the categories described previously, thereby relieving the federal court of its duty to follow state law. In all of these situations, although the basic claim arises under state law, the case invokes some federal interest.

Do the same considerations apply in bankruptcy? The courts have afforded little guidance on this issue.⁷⁰ Admittedly, bankruptcy is traditionally

65. *Euster v. Eagle Downs Racing Ass'n*, 677 F.2d 992 (3d Cir.), *cert. denied*, 459 U.S. 1022 (1982).

66. *Abraham v. Volkswagen of America, Inc.*, 795 F.2d 238, 248-49 (2d Cir. 1986) (Magnuson-Moss Warranty Act claim).

67. See *supra* notes 65 & 66.

68. *Colorado v. New Mexico*, 459 U.S. 176 (1982), *cert. denied*, 467 U.S. 310 (1984), *reh'g denied*, 468 U.S. 1224 (1983); *Illinois v. City of Milwaukee*, 406 U.S. 91 (1972) (federal common law governs the dispute). See generally Note, *Rules of Decision in Nondiversity Suits*, 69 YALE L.J. 1428 (1960).

69. See *supra* text accompanying notes 55-59.

70. *But see* *Fore Improvement Corp. v. Selig*, 278 F.2d 143, 147 (2d Cir. 1960) (Friendly, J., concurring) (asserting that the Decision Act should apply in bankruptcy absent any overriding federal policy).

Regardless of whether the Decision Act applies generally to all nondiversity cases, there is language in the Supreme Court's opinion of *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156 (1946), which indicates that the *Erie* doctrine does not apply in bankruptcy. As discussed above, if *Erie* does not apply in bankruptcy, the Decision Act does not either.

Vanston Bondholders, however, does not actually stand for the proposition that *Erie* is irrelevant in bankruptcy. The Court did not decide that federal law determines the substantive rights of the parties outside of bankruptcy. Instead, the Court merely held that even if the claim for compound interest at issue in that case was valid under state law, it was not the type of claim that would give the creditor the right to participate in the bankruptcy proceeding. *Id.* at 163. The right of a creditor to participate in bankruptcy is essentially a federal right. Although the bankruptcy court must look to state law to determine who is a "creditor," it looks to federal law to determine if that creditor's state law claim is allowed. Because *Vanston Bondholders* did not involve state law rights, it should not be read for the proposition that *Erie* is inapplicable in bankruptcy.

viewed as a uniquely federal remedy. The federal bankruptcy power is one explicitly granted to Congress in the Constitution.⁷¹ Although the states are not barred by the bankruptcy clause from regulating insolvency,⁷² the constitutional prohibition on state impairment of contracts⁷³ greatly limits the states' ability to grant the fundamental relief associated with bankruptcy - the discharge of debt. Further, under the current legislative scheme, only federal courts have jurisdiction to administer bankruptcy cases.⁷⁴ These factors indicate that the federal government does have a strong interest in bankruptcy.

Nevertheless, this federal interest is not of sufficient magnitude to override the Decision Act. Bankruptcy presupposes an existing network of state laws. Essentially, bankruptcy is a mechanism for the efficient resolution of state law claims, not a new federal body of rights and obligations supplanting state law. Except in certain narrow areas, the Code does not require a court to ignore state law rules.⁷⁵ Even though there are federal concerns present

71. U.S. CONST. art. I, § 8.

72. *Sturges v. Crowninshield*, 17 U.S. (4 Wheat.) 122 (1819), indicates that the bankruptcy power is not exclusive. In the absence of federal legislation, the states may (and have) enacted bankruptcy laws.

73. U.S. CONST. art. I, § 10.

74. The jurisdictional statutes applicable in bankruptcy are cited and discussed *supra* at note 7. Under this jurisdictional scheme, virtually all of the litigation related directly to the bankruptcy case will be conducted by a bankruptcy court. Matters that are tied less directly to the bankruptcy case may be heard by a state court.

75. There are, of course, several instances in which the Code explicitly displaces state law rules. See, e.g., 11 U.S.C. § 724(b) (1982 & Supp. IV 1986) (special priority rules for tax liens). In only one instance, however, does the Code explicitly displace state *choice of law* rules. In section 522(b)(2)(A), an individual debtor is allowed to elect to use state law exemptions. This subsection states that the applicable state law exemptions are those which are "applicable on the date of the filing of the petition at the place in which the debtor's domicile has been located for the 180 days immediately preceding the date of the filing of the petition, or for a longer portion of such 180-day period than in any other place" 11 U.S.C. § 522(b)(2)(A) (1982). Thus, section 522(b)(2)(A) empowers the court to ignore state choice of law rules relating to exemptions.

The court in *In re Knight*, 76 Bankr. 857 (Bankr. M.D. Ga. 1987), suggested that Congress intended a much broader displacement of state choice of law rules in bankruptcy. Under section 502(b)(1), a contractual claim is allowable only if it is enforceable under "applicable law." 11 U.S.C. § 502(b)(1) (1982 & Supp. IV 1986). The court in *Knight* viewed this language as an authorization to ignore the forum's choice of law rule (under which the contract would be illegal) in favor of "the law of the place where the contract was made" (under which the contract was fully enforceable). 76 Bankr. at 860.

The argument is appealing on its face. As discussed *infra* at text accompanying notes 108-11, *Klaxon* relies in large part on the Decision Act. This act, however, requires the federal court to apply state law only when there is no federal law or treaty to the contrary. Whenever the phrase "applicable law" appears, the argument continues, Congress has specified to the contrary, thereby pushing the case outside of the Decision Act and *Klaxon*. Since the phrase "applicable law" appears on more than forty-five occasions in the Code itself, the bankruptcy court is free to ignore state conflicts rules in many circumstances.

Nevertheless, the argument is probably misguided. The more logical interpretation of "applicable law" is that Congress is directing the court to use nonbankruptcy substantive law instead of bankruptcy law to resolve the issue. This directive is not the same as giving the

in bankruptcy that are not present in diversity suits, this in and of itself does not remove bankruptcy cases from the reach of the Decision Act. Aside from a possible federal policy in favor of granting a discharge, there is no overriding policy which would affect the resolution of state law issues in a bankruptcy proceeding.⁷⁶ In addition, unlike cases involving obligations of the federal government, there is no pressing need for national uniformity in the administration of the bankruptcy laws.⁷⁷ Therefore, using state law in bankruptcy is generally consistent with the federal statutory scheme.

Similarly, there is no overriding federal interest in the resolution of individual bankruptcy cases. Most bankruptcy cases affect primarily the obligations of private individuals or business entities.⁷⁸ In areas where the federal government does have an interest, such as federal income tax liens, Congress has generally protected the federal government's interest through various provisions in the Code.⁷⁹ Accordingly, the broad federal interest in the existence of a bankruptcy system does not authorize a wholesale substitution of federal law for state law in bankruptcy.

This is not to say that there are not instances in which bankruptcy courts may ignore state law. Although bankruptcy is built upon a base of state law rights, the terms and operation of bankruptcy laws are clearly a matter within the purview of the federal government. A state may attempt to dictate the result in a bankruptcy case by careful draftsmanship of state law. If a state enacts a rule which is designed to obstruct the effects of the Code, the bankruptcy court should have the power to ignore that state law.⁸⁰ Although the states define the "web" of relationships that exist on the date of bankruptcy, the states generally do not have the power to control what bankruptcy does to that web.⁸¹ The federal government, not the states, dictates the position of the various creditors following bankruptcy.⁸²

bankruptcy court the power to ignore state conflicts rules, which are part and parcel of the state substantive law. In addition, section 522(b)(2)(A) explicitly directs the bankruptcy courts to use a specific forum's law. This indicates that Congress was willing to displace state choice of law rules when it considered it to be important.

76. Hill, *supra* note 14, at 1047.

77. A bankruptcy proceeding involves primarily private rights. Thus, the outcome of an issue in a bankruptcy case is not likely to have any impact beyond the parties in the case itself. The result certainly is unlikely to affect any nationwide program. *In re Lady Madonna Indus., Inc.*, 76 Bankr. 281, 288-89 (S.D.N.Y. 1987) (no need for federal rule governing validity of settlement agreements in bankruptcy).

78. The adjustment of a municipality's debt, as provided by chapter 9 of the Code, is clearly an exception to this. Nevertheless, there will not be, in most instances, a strong *federal* interest in the outcome of a municipal bankruptcy case.

79. See, e.g., 11 U.S.C. §§ 507(a)(7), 724(b) (1982 & Supp. IV 1986) (special provisions protecting the interest of the federal taxing authorities).

80. See generally Countryman, *supra* note 46, at 420-26. See also *infra* note 97.

81. A notable exception is the area of exemptions, in which Congress gave the states the power to control whether the Code's exemption provisions apply in bankruptcy cases in that state. 11 U.S.C. § 522(b) (1982).

82. Congress also recognized the threat that aberrant state laws pose to the federal bankruptcy process. As a result, several provisions of the Code allow the bankruptcy court to disregard certain state laws that create special rules for bankruptcy cases. See, e.g., 11 U.S.C.

The federal interest in the choice of governing law may be somewhat stronger in a case involving bankruptcy remedies. Unlike the mixed state claims, which are rooted primarily in state law, bankruptcy remedies are created by federal statute. Because a federal statute supplies the cause of action, it can be argued that federal law should also be used to interpret all aspects of that federal remedy, even the underlying state law components.

Of course, the fact that a cause of action arises under a federal statute is not controlling. A federal court adjudicating a bankruptcy remedy is not merely borrowing state law to "fill in the gaps" in a federal statute.⁸³ State law is relevant in bankruptcy remedies insofar as it establishes the foundation on which the federal remedy is constructed. Although the Decision Act may not apply in interpreting the language of the Code, it should have some relevance in the interpretation of underlying state rights.

There is nevertheless some case authority implying that the Decision Act is irrelevant in construing bankruptcy remedies. The Supreme Court has indicated in several roughly analogous nonbankruptcy cases that the Decision Act is not controlling in situations in which the primary cause of action arises under a federal statute.⁸⁴ The most recent of these decisions is *Burks v. Lasker*.⁸⁵ In *Burks*, the basic claim before the Court was a derivative suit involving claims arising under several federal statutes regulating investment advisors.⁸⁶ In order to resolve the claims, the Court had to determine whether the directors of the corporation were authorized to terminate the suit. Nothing in the applicable federal statutes touched upon the power of corporate directors. Even though the cause of action arose under a federal statute, the Court indicated that state law should normally be used to determine the powers of corporate directors.⁸⁷

§ 541(c)(1)(B) (1982 & Supp. IV 1986) (state laws which become effective only upon bankruptcy or insolvency are ineffective to prevent interests from passing to the bankruptcy estate); 11 U.S.C. § 545(1) (1982 & Supp. IV 1986) (statutory liens which arise only upon bankruptcy or insolvency are ineffective).

83. *DelCostello v. International Bhd. of Teamsters*, 462 U.S. 151 (1983), involves just such a borrowing. In *DelCostello*, the Court addressed the issue of which statute of limitations to apply to a federal labor statute which did not set forth its own limitations period. The Court eventually chose a limitations period from a different federal statute, instead of the state limitations period.

A "borrowing" case such as *DelCostello* is immediately distinguishable from the situation facing the bankruptcy court construing a bankruptcy remedy. In the borrowing situation, state law is relevant only because it is somewhat analogous to federal law. There is no suggestion that state law applies of its own right. In bankruptcy, however, many of the substantive rights to be interpreted are based upon state law.

84. *Burks v. Lasker*, 441 U.S. 471 (1979); *De Sylva v. Ballentine*, 351 U.S. 570 (1956), *reh'g denied*, 352 U.S. 859 (1955); *Sola Elec. Co. v. Jefferson Co.*, 317 U.S. 173 (1942). *But cf.* *Commissioner v. Bosch*, 387 U.S. 456 (1967) (suggesting that state law controls the nature of the property interest held by decedent, although decisions of lower courts are not necessarily dispositive of state law).

85. 441 U.S. 471 (1979).

86. *Id.* at 473.

87. *Id.* at 477-78. This situation is similar to that facing the bankruptcy court when adjudicating a bankruptcy remedy. In both instances, the primary right giving rise to the

The Court in *Burks*, however, stopped short of holding that the federal court must look to state law in the type of case presented by the facts of *Burks*. Instead, it stated that, as a matter of policy, the federal courts ordinarily should make a primary reference to state law in determining the nature of the underlying state law rights. The Court went on to enumerate various cases in which federal courts are free to ignore state law when adjudicating a federal remedy erected upon state law.⁸⁸ Although not technically decided under the Decision Act,⁸⁹ the *Burks* opinion implies that the Decision Act does not control where the gravamen of a complaint is a federal question. Instead, the Court held that federal courts in such cases should use state law unless there is some reason to the contrary.

If the Court in *Burks* meant to imply the Decision Act does not control the adjudication of state law issues germane to a federal remedy, it created a distinction without substance. The Court could have reached the same result by applying the Decision Act. Even if the Decision Act applies to cases such as *Burks*, federal law may nevertheless be used as the rule of decision. As discussed previously, the Court has recognized several categories of exceptions to the application of the Decision Act. These exceptions to the Decision Act closely parallel the situations discussed in *Burks*. Under the exceptions, for example, a federal court adjudicating a claim under a federal statute could apply federal law in lieu of state law if the federal statute so indicated or if application of state law would frustrate the purpose of the federal act.⁹⁰ Requiring federal courts to apply state law unless certain conditions are met is no different than "suggesting" that the courts apply state law in the absence of those conditions.⁹¹ In both situations, a lower court must apply state law unless specified conditions are satisfied. There is no language in the Decision Act creating a blanket exception for congressionally created remedies. Therefore, the Decision Act and its exceptions

lawsuit is one created by Congress. The federal right, however, is premised upon the existence of certain legal relationships that exist independent of the federal statute. These underlying legal relationships are for the most part created and defined by state law.

88. For example, the Court indicated that the federal court could ignore state law when the application of state law would be inconsistent with the federal policy underlying the cause of action, or when the application of state law would destroy the right created by the federal statute. *Id.* at 479.

89. The Court in *Burks* focused its analysis on the *Erie* doctrine. The technical holding of the case is that *Erie* does not dictate use of state law in adjudicating a federal question. As discussed below, however, the Decision Act is one of the foundations of the entire *Erie* doctrine. Accordingly, a necessary implication of the decision in *Burks* is that the Decision Act is not controlling.

90. Interestingly, the *Burks* Court withheld judgment on whether the state law in question actually conflicted with the federal statute. *Id.* at 480.

91. *Accord* Note, *supra* note 68, at 1449-50 (1960). In *De Sylva v. Ballentine*, 351 U.S. 570 (1956), *reh'g denied*, 352 U.S. 859 (1955), the Court indicated that the difference is insignificant. The issue in *De Sylva* was whether the term "children" in the Copyright Act of 1909 includes illegitimate children. The Court held that resolution of this issue "requires a reference to state law." *Id.* at 580.

should generally apply to federal remedies incorporating state law, absent language in the federal statutes to the contrary.⁹²

This conclusion is reinforced in bankruptcy. First, application of state law is entirely consistent with the Code. Congress generally intended that resolution of state law rights would be accomplished by reference to state law.⁹³ Therefore, only in rare situations will use of state law violate the purpose of the federal statute.

The federal government, however, also has another, more basic, interest in the bankruptcy remedies. Unlike most other claims involving state law rights that arise in a bankruptcy case, bankruptcy remedies exist in order to ensure that relief afforded by the Code is effective. For example, the purpose behind the preference and fraudulent conveyance provisions of the Code⁹⁴ is to prevent debtors from improving certain creditors' positions immediately prior to the filing of the petition. These provisions help preserve "equality" among similarly situated creditors. Such equality is considered basic to the bankruptcy process.⁹⁵ Therefore, to the extent state law interferes with attainment of fundamental bankruptcy goals, bankruptcy courts may be able to ignore the requirements of the Decision Act.

Nevertheless, even the strong federal interest in "equality" will normally be insufficient to overcome the Decision Act. Bankruptcy remedies are designed to protect against state laws which render ineffective the relief provided by the Code. However, the Code itself gives bankruptcy courts the ability to override state laws running counter to this federal interest. Several provisions establishing bankruptcy remedies contain language which prevents a state from avoiding the impact of the remedy by clever legislation.⁹⁶ Bankruptcy courts need not look beyond these provisions for authorization to defeat state attempts to control the result in bankruptcy. When interpreting bankruptcy remedies, then, a court's task is to determine

92. The lower courts are in accord with this conclusion. A number of courts have cited *Erie* as controlling in the adjudication of state law rights in bankruptcy. *Woods-Tucker Leasing Corp. v. Hutcheson-Ingram Devel. Co.*, 642 F.2d 744, 748 (5th Cir. 1981); *In re Busick*, 719 F.2d 922, 926 (7th Cir. 1983); *In re Citron Inv. Corp.*, 493 F.2d 561 (9th Cir. 1974); *Goldstein v. Madison Nat'l Bank*, 89 Bankr. 274 (D.D.C. 1988); *In re Dynamic Enterprises, Inc.*, 32 Bankr. 509 (Bankr. M.D. Tenn. 1983); *In re Concrete Structures, Inc.*, 23 Bankr. 605 (Bankr. E.D. Va. 1982). *But cf. In re Poole*, 15 Bankr. 422 (Bankr. N.D. Ohio 1981) (although state law governs an action to set aside a fraudulent conveyance under section 544(b), state law does not control on the issue of whether the bankruptcy court should issue a preliminary injunction in the course of the section 544(b) action).

93. See *supra* text accompanying notes 14-16.

94. 11 U.S.C. §§ 547, 548 (1982 & Supp. IV 1986) (respectively).

95. Section 545 serves a similar end. See 11 U.S.C. § 545 (1982 & Supp. IV 1986). Under section 545(1), the Code allows the trustee to avoid any statutory lien that becomes effective only upon bankruptcy. This provision preserves equality by preventing states from favoring a class of creditors in bankruptcy in situations where it is not willing to do so outside of bankruptcy.

96. See, e.g., 11 U.S.C. § 545 (1982 & Supp. IV 1986). Under section 545, the state is free to treat certain creditors more favorably than others. In order for the state priority rules to stand up in bankruptcy, however, the state must also give the creditor priority over a bona fide purchaser. 11 U.S.C. § 545(2) (1982 & Supp. IV 1986).

whether the congressionally established criteria have been violated. In other words, a court must determine the substance of a state's law before determining whether it violates one of the restrictions of the Code. In ascertaining the content of state law, there is no reason why a bankruptcy court should not refer to state law. Only by so doing can a bankruptcy court interpret state law with any accuracy.⁹⁷ Accordingly, the Decision Act will generally require the bankruptcy court to use state law to resolve state law rights germane to bankruptcy remedies.⁹⁸

3. *The Decision Act and Choice of Law*

The foregoing discussion demonstrates that unless some component of federal law or federal policy indicates otherwise, the Decision Act requires a bankruptcy court to utilize state law when adjudicating state law rights presented to it in a bankruptcy case. Indeed, the Act seems almost redundant when applied in bankruptcy. If the bankruptcy process is viewed as a federal procedure for dealing with state law, it is consistent to look beyond the terms of the Code when determining the scope of state law rights.

The Decision Act, however, does not resolve the next issue; namely, which state's law is to be applied. The Act speaks of applying state law as the "rule of decision." The phrase "rule of decision," however, is not defined. More specifically, it is unclear whether a state's choice of law rules are rules of decision. Logically, however, the phrase should encompass a state's entire body of law, including its choice of law rules. A state's "substantive" rule cannot be considered a "rule of decision" unless the adjudicating court elects to use that state's rule. If one views a state's choice of law rules as an integral part of its "substantive" law, the mandate of the Decision Act clearly encompasses choice of law rules.

Even if the Decision Act does require use of state choice of law rules, however, it is silent on the methodology that federal courts must use in selecting applicable choice of law rules. In other words, the Decision Act does not indicate the state to which federal courts should look for applicable

97. This is not to say that state law may not interfere with the Code in areas not protected by the bankruptcy remedies. For example, the state may attempt to "disguise" state law rights in order to shield these rights from the trustee's avoidance powers. *Elliott v. Bumb*, 356 F.2d 749 (9th Cir. 1966), *cert. denied*, 385 U.S. 829 (1966), presents just such a case. In *Elliott*, the court found that the state was attempting to disguise a statutory lien by calling it a trust. *Id.* at 755. If the arrangement was a statutory lien, it would be voidable. If characterized as a trust, funds held by the debtor would not pass to the bankruptcy trustee, but instead would go to the "beneficiary" of the "trust." To prevent the state law from contravening the intent of the Code, the court treated the state law rights as a lien, and subjected the arrangement to the avoidance powers. *Id.*

Elliott, however, does not stand for the proposition that the bankruptcy court may ignore state law in its entirety. Instead, *Elliott* simply indicates that the bankruptcy court may look beyond the *label* that a state places on its law and look instead to the substance. In order to determine these underlying substantive rights, the court should look to state law.

98. Again, one must distinguish the above analysis from the analysis of *which* state's law is to be applied. This latter question presents additional considerations which are the subject of the remainder of this article.

choice of law rules. In moving to the realm of choice of law, one must transcend the strict limits of the Decision Act. The most important body of law dealing with choice of law in federal courts is the *Klaxon* arm of the *Erie* doctrine. The *Klaxon* rule determines the manner in which federal courts are to decide a choice of law question in cases governed by the *Erie* doctrine. The *Erie* doctrine, however, is based in large part upon the Decision Act.⁹⁹ Therefore, the discussion of the Decision Act remains highly relevant even in considering the impact of the *Klaxon* rule.

C. Transforming the Decision Act into *Klaxon*

As already indicated, many of the rights adjudicated by a bankruptcy court arise under state law. If those same rights were presented to a diversity court for adjudication, resolution of the choice of law question would be clear. Under the rule set out by the Supreme Court in *Klaxon*¹⁰⁰ and the companion case of *Griffin v. McCoach*,¹⁰¹ a diversity court is required to adopt forum choice of law rules. Because a bankruptcy court is also a federal court, the question of which state law is to be used in deciding state law rights in bankruptcy cannot be resolved without determining the applicability of *Klaxon*. The crux of the *Klaxon* rule is that the mandate of *Erie*¹⁰² extends not only to a state's substantive law but also to state choice of law rules.¹⁰³ If courts of the forum state would apply the law of State

99. See *infra* text accompanying notes 108-11.

100. 313 U.S. 487 (1941).

101. 313 U.S. 498 (1941). For the sake of convenience, the doctrine set out in the *Klaxon* and *Griffin* opinions will be referred to as the *Klaxon* doctrine.

102. The procedural history of *Erie* itself presented the Supreme Court with a choice of law issue. The accident giving rise to the *Erie* litigation occurred in Pennsylvania. The lawsuit itself was filed in the Southern District of New York. After reversing the lower courts' use of "general federal common law" to decide the substantive rights of the litigants, Justice Brandeis' majority opinion stated that the liability of the Erie Railroad should have been determined in accordance with Pennsylvania common law. 304 U.S. at 71.

This conclusion is not immediately obvious. Indeed, the general rule announced in *Erie* could easily be interpreted to require the lower court to apply the substantive law of the forum state - New York. The opinion does not state why Pennsylvania instead of New York law should govern. Various theories have been suggested as to why Justice Brandeis neglected to discuss this aspect of the holding. Compare Hart, *The Relations Between State and Federal Law*, 54 COLUM. L. REV. 489, 514 n.84 (1954)(the majority in *Erie* must have assumed that federal law governed the choice of law question) with Friendly, *In Praise of Erie - And of the New Federal Common Law*, 39 N.Y.U. L. REV. 383, 401 (1964)(the Court must have assumed, without so stating, that a New York court in these circumstances would have applied Pennsylvania substantive law to the issue).

103. Earlier in its 1940-1941 term, the Court issued an opinion which suggested just the contrary. In *Sibbach v. Wilson & Co., Inc.*, 312 U.S. 1 (1940), a party was challenging the validity of Federal Rule of Civil Procedure 35, which authorizes the district court to order a party to submit to a mental or physical examination. The Court held that the Rule was valid. *Id.* at 16. It further suggested, however, that, in the absence of the Federal Rule, the Decision Act would require the district court to look to the law of the state where the cause of action arose (Indiana) for the governing substantive law. The Court never discussed what the conflict of law rules of the forum state (Illinois) would require. *Id.* at 10-11. Therefore, the Court intimated that the choice-of-law question could be decided without reference to forum law.

A in deciding a dispute, a diversity court must do the same. The diversity court is not free to choose for itself which state has the most significant nexus with the underlying dispute.

Neither *Klaxon* nor *Griffin* shed much light on the reason for extending the rule in *Erie* to the conflicts issue. Instead, the Court in each opinion simply held that the *Erie* doctrine applies with equal force in the choice of laws area.¹⁰⁴ In so holding, the Court stated that the central theme underlying *Erie* is uniformity between the state and diversity courts situated within a given jurisdiction.¹⁰⁵ To ensure uniformity of result, a federal district court must apply the substantive law that would be applied by a court of the forum state. Under *Erie* and *Klaxon*, then, a diversity court acts as merely another state court.¹⁰⁶

The *Klaxon* rule has generally been interpreted in the context of diversity cases. Nevertheless, a substantial number of bankruptcy courts have determined that the rule also applies in bankruptcy cases.¹⁰⁷ This conclusion is not immediately obvious. Even though the Decision Act applies to the adjudication of state law rights in bankruptcy, the *Klaxon* rule is not a necessary implication of the Decision Act. The Decision Act is silent on the choice of law question. The *Klaxon* rule, then, although based in part upon the Decision Act, also involves other considerations relevant to state law litigation in federal courts. To determine the extent to which *Klaxon* applies in bankruptcy, one must separate the rule into its component parts. Any discussion of the *Klaxon* rule begins with an understanding of *Erie* and its precepts.

1. The Decision Act

Aside from its constitutional aspects, *Erie* can be interpreted simply as a decision construing the reach of the Decision Act. Thus construed, *Erie* holds that the rule of *Swift v. Tyson*¹⁰⁸ incorrectly restricts the reach of the

104. *Klaxon*, 313 U.S. at 496; *Griffin*, 313 U.S. at 503. This dearth of discussion has subjected *Klaxon* and *Griffin* to a great deal of criticism. Perhaps the strongest criticism is that levied in HART & WECHSLER, *supra* note 49, at 794-800 (describing *Klaxon* as a "rather simplistic extension of *Erie* . . ."). See also Trautman, *The Relation Between American Choice of Law and Federal Common Law*, 41 LAW & CONTEMP. PROBS. No. 2, 105 (Spr. 1977); Horowitz, *Toward a Federal Common Law of Choice of Law*, 14 UCLA L. REV. 1191, 1200-10 (1967). For a defense of *Klaxon*, see Ely, *The Irrepressible Myth of Erie*, 87 HARV. L. REV. 693, 714-15 n.125 (1974).

Although the rule has been widely criticized, the Supreme Court has shown no inclination to reconsider it. Indeed, the *Klaxon* rule was held controlling in *Day & Zimmerman, Inc. v. Challoner*, 423 U.S. 3 (1975). In *Challoner*, the Court held that the district court must apply the forum's choice-of-law rule, even though this meant that the substantive law of Cambodia would govern the dispute between the parties instead of the substantive law of Texas. *Id.* at 5.

105. *Klaxon*, 313 U.S. at 496. This "uniformity" logic also underlies the Supreme Court's later opinions in *Guaranty Trust Co. v. York*, 326 U.S. 99 (1945), and *Bernhardt v. Polygraphic Co. of America, Inc.*, 350 U.S. 198 (1956).

106. *Cf. Guaranty Trust Co. v. York*, 326 U.S. 99 (1945).

107. See cases cited *supra* notes 42 & 43.

108. 41 U.S. (16 Pet.) 1 (1842).

Decision Act to actions arising under state statutes.¹⁰⁹ By extending the scope of the Act to actions at common law, *Erie* stands for the proposition that Congress has ordered federal courts to follow state law whenever state law rights are adjudicated.

Even though the Decision Act forms one of the foundations of *Erie*, it is unclear whether the Act supports the Court's extension of the *Erie* doctrine in *Klaxon*. The opinions in *Klaxon* and *Griffin* do not mention the Decision Act as a basis for the rule. The logic underlying the decisions, however, indicates that the Decision Act does require the use of state choice of law rules. A key element of the *Klaxon* holding is the notion that the choice of law rules of a state are part and parcel of the substantive rights afforded litigants under the laws of that state.¹¹⁰ This conclusion is also extremely useful in interpreting the Decision Act. Because the Decision Act requires that state-created rights be adjudicated in accordance with state law, it concords fully with the result in *Klaxon*.¹¹¹ *Klaxon* implies that "rules of decision" a federal court must apply under the Decision Act include those rules used by state courts in selecting a body of law to adjudicate the controversy. Therefore, *Klaxon* can be read as an important interpretation of the Decision Act.

2. *The Constitution*

The majority opinion in *Erie* clearly indicates that the decision was based in part upon the Constitution. For reasons that have puzzled students and scholars alike, Justice Brandeis' majority opinion in *Erie* suggests that the abandoned rule of *Swift* was not only wrong, but also in violation of the Constitution.¹¹² Unfortunately, Brandeis' opinion in *Erie* does not specify the provision of the Constitution that was violated by the then prevailing practice in federal courts.¹¹³ Today, fifty years after the *Erie* decision, most have concluded that Brandeis believed the federal courts, in creating a

109. Indeed, Justice Reed, concurring in the *Erie* opinion, indicated that the decision should have been confined to the Decision Act issue. 304 U.S. at 91-92 (Reed, J., concurring).

110. This rationale is expressed with the greatest emphasis in *Griffin v. McCoach*, 313 U.S. at 504.

111. *Accord Cavers, Change in Choice-of-Law Thinking and Its Bearing on the Klaxon Problem*, THE AMERICAN LAW INSTITUTE, STUDY OF THE DIVISION OF JURISDICTION BETWEEN STATE AND FEDERAL COURTS 154 (Tent. Draft No. 1 1963).

112. 304 U.S. at 79.

113. The majority opinion states, "We merely declare that in applying the doctrine [of *Swift v. Tyson*] this Court and the lower courts have invaded rights which in our opinion are reserved by the Constitution to the several states." 304 U.S. at 80. Because of the failure of the *Erie* majority to specify an explicit provision, the constitutional discussion in *Erie* has often been dismissed as mere dictum. See, e.g., Clark, *State Law in the Federal Courts: The Brooding Omnipresence of Erie v. Tompkins*, 55 YALE L.J. 267, 278 (1946); Currie, *Change of Venue and the Conflict of Laws*, 22 U. CHI. L. REV. 405, 468-69 (1955). The better view is that the Court meant what it said, and that, under the facts of *Erie* itself, ignoring state substantive law would violate some express or implied restriction of the Constitution. See Ely, *supra* note 104 at 702-03 n.59; Hill, *The Erie Doctrine and the Constitution (Part I)*, 53 NW. U.L. REV. 427, 439-49 (1958); C. WRIGHT, A. MILLER & E. COOPER, FEDERAL PRACTICE AND PROCEDURE 52-54 (1982).

general federal common law under *Swift*, were acting outside the enumerated powers granted to the federal government by the Constitution.¹¹⁴ Nothing in the Constitution gives federal courts the power to create, through adjudication, general substantive rules of common law to govern private, state law disputes. Further, none of the powers granted to Congress would authorize the enactment of a general scheme of common law rules.¹¹⁵ Because federal courts have no inherent constitutional authority to create federal common law, and because Congress could not have delegated to the federal courts a general lawmaking authority which Congress did not have itself, *Swift's* interpretation of the Decision Act allowed federal courts to exceed their constitutional powers.¹¹⁶

After *Erie*, the Supreme Court used the constitutional argument on only rare occasions.¹¹⁷ Nevertheless, the Court dusted the argument off in the important decision of *Hanna v. Plumer*.¹¹⁸ *Hanna* reinforced the view that the federal government is one of limited powers, and that an attempt to create substantive law in areas outside the enumerated powers of the Constitution will not be allowed.

Although *Hanna* revived the constitutional argument of *Erie*, it also recognized the argument's limits. One can infer from the *Hanna* opinion that the constitutional argument of *Erie* may not apply to choice of law rules enacted for use in bankruptcy. The Constitution does not authorize

114. Ely, *supra* note 104, at 702-04. Other interpretations of *Erie's* "constitutional" aspect are possible. For example, Justice Brandeis indicates that the then-current interpretation of *Swift* "rendered impossible equal protection of the law." 304 U.S. at 75. Nevertheless, it is difficult to view *Erie* as a decision based upon the equal protection clause. See generally P. Low & J. Jeffries, *FEDERAL COURTS AND THE LAW OF FEDERAL-STATE RELATIONS* 272-75 (1987).

115. Ely, *supra* note 104, at 704. Professor Ely also notes that the specific issue in *Erie* - the degree of negligence necessary to confer liability on the defendant - was probably within the purview of Congress, even given the somewhat restrictive interpretation of the commerce clause powers in effect in 1938. *Id.* at 703 n.62. This, however, does not affect Justice Brandeis' analysis. The real issue is whether Congress has *general* lawmaking authority - which may in turn be delegated to the federal courts. *Id.*

116. *Id.* at 704.

117. The next Supreme Court case in which the argument appears is *Bernhardt v. Polygraphic Co.*, 350 U.S. 198 (1956); the constitutional argument is mentioned in dictum. As noted by Professor Ely, *Bernhardt* confused the constitutional argument of *Erie* by suggesting that a general federal common law would invade a realm of authority reserved to the states. Ely, *supra* note 104, at 705-06 (noting *Bernhardt*, 350 U.S. at 202).

Even if this argument did correctly represent the Court's view, subsequent decisions have rendered the argument of little force. The cornerstone of this theory - that there is an "enclave" of powers reserved to the states by the Constitution - has been rejected by the Court in recent years. Although the notion was resuscitated briefly in *National League of Cities v. Usery*, 426 U.S. 833 (1976), it was again laid to rest in *Garcia v. San Antonio Metro. Transit Auth.*, 469 U.S. 528 (1985). Consequently, one need look no further than the powers explicitly granted to the federal government in the constitution itself, augmented by those implied powers that are "necessary and proper" to implement one of the enumerated powers, in order to determine what is within the permissible scope of federal activity. See also P. Low & J. Jeffries, *supra* note 114, at 273-74.

118. 380 U.S. 460 (1965).

Congress to replace state tort law with federal law. It does, however, grant Congress the power to enact bankruptcy laws.¹¹⁹ In addition, article I and article III of the Constitution enable Congress to establish lower federal courts.¹²⁰ The “necessary and proper” clause of the Constitution¹²¹ authorizes Congress to enact those laws needed for the proper exercise of Congress’ enumerated powers. Therefore, Congress certainly has the power to enact a system of bankruptcy courts to give effect to the bankruptcy laws.¹²² Because Congress has the power to create bankruptcy courts, it also has the implied power to establish, either directly or by delegation to the courts themselves, rules of procedure to be utilized by those courts. If establishing federal choice of law rules falls within the federal power to regulate the procedure of the bankruptcy courts, it follows that the constitutional element of *Erie* and *Klaxon* would not apply.

Unfortunately, this question cannot be easily answered. It is unclear whether Congress’ power to establish a system of courts pursuant to an article I of the Constitution includes the power to dictate a set of choice of law rules for those courts.¹²³ There is an outer limit on Congress’ ability to enact legislation under the bankruptcy power. The parameters of the article I bankruptcy power, however, have never been clearly defined.¹²⁴

119. *Id.* at 471-72.

120. U.S. CONST. art. I, § 8, cl. 9; *id.* art. III, § 1.

121. U.S. CONST. art. I, § 8, cl. 18.

122. Technically, the Bankruptcy Courts are not “pure” legislative courts. *Northern Pipeline Const. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50, 63 (1982). Accordingly, they differ from the territorial courts, which were created for the purpose of implementing Congress’ article I power to govern the territories. Instead, the Bankruptcy Courts lie in a gray area between article I courts and article III courts; they are vested with certain duties under each article. This distinction does not affect the above analysis. The “necessary and proper” clause is not limited to Congress’ article I powers, but also applies to “all other Powers vested by this Constitution in the Government of the United States, or in any Department or Officer thereof.” U.S. CONST. art. I, § 8.

123. HART & WECHSLER, *supra* note 49, at 794, suggests that even if the issue of substantive law presented in *Erie* was beyond the power of Congress, Congress could nevertheless enact choice of law rules for the federal courts, which would apply even in diversity cases. These authors argue that Congress has the authority to enact choice of law rules as necessary and proper either to the full faith and credit clause or to Congress’ article I power to establish a system of federal courts. In other words, the power to establish a system of lower federal courts includes the power to regulate all aspects of procedure in those courts, including choice of law rules. *Accord* Friendly, *supra* note 102, at 402.

Likewise, even if Congress does not have the ability to enact choice of law rules, it has been suggested that the Supreme Court may have an implied power to do so as part of its power to administer the lower federal courts. Memorandum, *The Constitutionality of Authorizing Independent Federal Determination of Choice of Law in Diversity of Citizenship Cases*, AMERICAN LAW INSTITUTE, STUDY OF THE DIVISION OF JURISDICTION BETWEEN STATE AND FEDERAL COURTS 442, 443-48 (1969) [hereinafter ALI STUDY]; Hill, *The Erie Doctrine and the Constitution (Part II)*, 53 NW. U.L. REV. 541, 565 (1958). Taken together, these arguments imply that the constitutional underpinnings of *Erie* cannot be used to support the result in *Klaxon*. *Accord* Cavers, *supra* note 111, at 154.

124. The Supreme Court has on only two occasions found that a federal law exceeded Congress’ article I bankruptcy power. In *Ashton v. Cameron County Water Improvement*

Even given the limited precedent, it is reasonable to conclude that Congress has the power to establish choice of law rules for federal courts. The Supreme Court has recognized in other contexts that the "necessary and proper" clause gives Congress significant latitude in regulating procedure in federal courts established pursuant to article III of the Constitution.¹²⁵ Therefore, to the extent the choice of law issue is one of procedure, Congress could arguably rely upon the necessary and proper clause to enact choice of law rules for bankruptcy courts created under its article I power. These choice of law rules would not violate the Constitution merely because they substitute a uniform set of conflicts rules for existing state rules. If Congress has the power to enact a law on a given subject, it also has the power to displace state law on that subject.¹²⁶ The constitutional underpinnings of

Dist. No. 1, 298 U.S. 513 (1936), the Court held unconstitutional that portion of the 1898 Bankruptcy Act pertaining to municipal bankruptcies, stating that it was an encroachment on state powers. The Court later retreated from this position in *United States v. Bekins*, 304 U.S. 27 (1938). Since *Bekins*, the Court has retreated even further from the notion of an "enclave" of powers reserved exclusively to the states. See *supra* note 117. Therefore, it is highly questionable whether *Ashton* is still valid.

More recently, in *Railway Labor Executives' Assoc. v. Gibbons*, 455 U.S. 457 (1982), the Court invalidated the Rock Island Transition and Employee Assistance Act, which had a direct impact on the pending liquidation of the defunct Rock Island Railroad. Because this act applied only to a single debtor, it violated the "uniformity" requirement of article I, section 8 of the Constitution. *Id.* at 473. For a criticism of *Gibbons*, see Baird, *Bankruptcy Procedure and State-Created Rights: The Lessons of Gibbons and Marathon*, 1982 THE SUP. CT. REV. 25, 26-36.

In addition to these decisions, the Court has invalidated bankruptcy laws on constitutional grounds in only four other instances. One of these is the celebrated *Northern Pipeline* decision, in which the Court held that the Code's broad grant of subject matter jurisdiction to the newly-created Bankruptcy Courts was unconstitutional. *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50, 84 (1982). The crux of the decision, however, was article III and the doctrine of separation of powers. The other three cases deal with more technical issues. In *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555, 602 (1935), the Court held that a provision of the Frazier-Lemke Act violated the fifth amendment. In *Hoffman v. Connecticut Dep't of Income Maintenance*, 109 S. Ct. 2818 (1989), the Court held that the provisions giving the bankruptcy courts jurisdiction over claims against the states could, in certain circumstances, violate the eleventh amendment. Finally, in *Granfinanciera, S.A. v. Nordberg*, 109 S. Ct. 2782 (1989), the Court held that the provisions of the Judicial Code governing the right to a jury trial in bankruptcy were inconsistent with the requirements of the seventh amendment. These decisions indicate that Congress cannot use its bankruptcy power to violate other restrictions of the Constitution. As such, they are not terribly helpful in defining the theoretical scope of the bankruptcy power itself. This leaves *Gibbons* as the only Supreme Court decision pronouncing an outer limit on the bankruptcy power.

Because of this paucity of material, the actual scope of Congress' power to enact bankruptcy laws is unclear. For a general discussion of some of the possible limits of the bankruptcy power, see Hill, *supra* note 14, at 1036-38.

125. *Budinich v. Becton Dickinson & Co.*, 486 U.S. 196 (1988) (if a statute is "rationally capable of classification" as a procedural rule, it is necessary and proper for implementing Congress' power to establish federal courts); *Hanna v. Plumer*, 380 U.S. 460, 472 (1965).

126. U.S. CONSR. art. VI, § 2. See generally *Westen & Lehman*, *supra* note 6, at 314-15. Even if *Klaxon* applies in bankruptcy, Congress would nevertheless have some control over the choice of law question. *Klaxon* requires the federal court to refer to the choice of law

Erie do not apply when Congress has spoken on the subject. Instead, the constitutional aspects of *Erie* are based on a fear that the federal courts were creating law in an area in which the federal government was not empowered to act. Assuming, then, that Congress' choice of law rules do not violate some other provision of the Constitution,¹²⁷ they would override any constitutional considerations that might arise from *Erie*.

Accordingly, Congress could enact choice of law rules for the bankruptcy courts without exceeding the scope of its enumerated powers. Applying the *Erie* logic, nothing in the Constitution prevents the bankruptcy courts from establishing choice of law rules in the context of adjudicating a bankruptcy case. The court's inherent power to formulate such rules arises from their power to regulate their own procedure. The only restrictions on bankruptcy courts' ability to formulate choice of law rules come not from the Constitution, but instead from Congress. Therefore, the constitutional underpinnings of *Erie* would not prohibit federal choice of law rules in the bankruptcy courts.¹²⁸

rules of the forum. Assuming that Congress could find a state whose choice of law rules were in accordance with Congress' desires, it could dictate the use of the preferred rules by altering the venue statutes to require all cases to be brought in that forum. This venue rule would be valid as long as it did not violate the litigants' fifth amendment due process rights. See *infra* note 127.

It is unlikely, however, that Congress could, under its bankruptcy power, enact a Code of substantive legal rules that would replace all state rules of decision in a bankruptcy case. Conceptually, bankruptcy is a federal system built upon an existing network of state law (and nonbankruptcy federal law) rights. Accordingly, Congress does have the power to displace state law when that state law is inconsistent with the purposes of bankruptcy. See, e.g., 11 U.S.C. § 545(1) (1982 & Supp. IV 1986) (statutory liens that become effective only upon bankruptcy or insolvency may be avoided). This ability to displace state law would not warrant a wholesale substitution of federal substantive law for the entire underlying web of state law rights. Most state laws are fully consistent with the purposes behind the Code.

127. For example, the Supreme Court has indicated that an arbitrary choice of law rule may violate the due process rights of the litigants. *Phillips Petroleum Co. v. Shutts*, 472 U.S. 797, 823 (1985). *Phillips* dealt with a lawsuit originally adjudicated in a state court; thus, it is not clear whether it is applicable to litigation in the federal courts. The Court's rationale was based in part on the full faith and credit clause. In addition, in its discussion of due process, the applicable constitutional provision was the due process clause of the fourteenth amendment. *Id.* at 814-23. The federal courts are bound by neither the full faith and credit clause nor the fourteenth amendment. Nevertheless, the federal government is required to afford citizens due process under the fifth amendment. Although the fifth amendment restrictions may not exactly parallel those of the fourteenth amendment, there should be similar considerations. Cf. Fullerton, *Constitutional Limits on Nationwide Personal Jurisdiction in the Federal Courts*, 79 Nw. U.L. REV. 1, 14-17 (1984). For example, a choice of law system would arguably run afoul of due process limitations (either the fifth or fourteenth amendment) if it was completely arbitrary or if the system consistently chose the substantive law of a forum having no connections whatsoever with the underlying dispute. Therefore, to the extent that the decision in *Phillips* relies upon due process considerations, it indicates that any national choice of law rule adopted by Congress for use in the bankruptcy courts would have to afford due process to the litigants.

128. In theory, Congress could deprive the federal courts of all authority to control their own procedure. To date, Congress has not chosen to do so.

3. *Forum Shopping*

As further justification for its conclusion, the majority opinion in *Erie* expressed concern that the rule in *Swift* provided an incentive for plaintiffs to control the outcome of a lawsuit by choosing between the federal and state courts in a jurisdiction.¹²⁹ Indeed, as the Court expounded upon the *Erie* doctrine in later cases, the fear of "forum shopping" emerged as the primary justification for the doctrine.¹³⁰ Forum shopping could exist whenever the outcome in federal court would be materially different than the outcome in state court. The federal courts could avoid the specter of forum shopping only by copying the state courts' application of substantive law.

The decision in *Klaxon* is fully consistent with this goal of avoiding forum shopping. A plaintiff may have an incentive to forum shop if a federal court will decide the case under a different body of substantive law than the courts of the forum. This threat of forum shopping exists not only in those situations where a federal court is considering using federal law instead of forum law. A federal court may also induce forum shopping if it applies the law of state *A* in cases where the state courts would apply the law of state *B*. In either situation, plaintiffs may have some control over the outcome of the litigation depending on their selection of a federal or state forum. *Klaxon* restricts forum shopping by requiring a federal court to look not only to state "substantive" law, but also to state choice of law rules. Therefore, a defendant is assured that the substantive rules of decision applied in any litigation in the forum will be identical regardless of the court chosen. With the addition of the *Klaxon* rule, a federal court interpreting state law rights must act for all intents and purposes as a state court.

Klaxon, then, is based upon two of the three concepts underlying *Erie*. Although these concepts are related, they each affect the scope of the *Klaxon* rule in a distinct way. In other words, each of these underlying concepts provides the justification for a different part of the entire rule in *Klaxon*. Therefore, *Klaxon* will dictate the resolution of the choice of law issue in bankruptcy cases only to the extent that each of these underlying concepts applies in bankruptcy.

129. *Erie*, 304 U.S. at 76-77.

130. *Hanna v. Plumer*, 380 U.S. 460 (1965). Actually, the Court in *Hanna* viewed *Erie* as having "twin aims": (1) discouraging forum shopping; and (2) avoiding "inequitable administration of the laws." 380 U.S. at 468. For the purposes of this discussion, it is unnecessary to determine what difference exists - if any - between the former aim and the latter. Indeed, as Professor Ely points out, forum shopping in and of itself is not evil. Forum shopping only becomes objectionable when it results in discrimination in favor of or against out-of-state litigants. Ely, *supra* note 104, at 710. Therefore, there is no practical difference between the "twin aims" set out by the *Hanna* Court. See also *Stewart Org., Inc. v. Ricoh Corp.*, 108 S. Ct. 2239 (1988) (Scalia, J., dissenting) ("The best explanation of what constitutes inequitable administration of the laws is that found in *Erie* itself: allowing an unfair discrimination between noncitizens and citizens of the forum state.").

IV. *The Application of Klaxon in Bankruptcy*

Nothing in the *Klaxon* or the *Griffin* opinions indicates that the rule created in those cases is controlling on the choice of law rules that are to be used by a bankruptcy court. In both cases, the Court explicitly restricted its holding to federal district courts sitting in diversity.¹³¹ Because bankruptcy courts have subject matter jurisdiction over bankruptcy-related disputes regardless of the existence of diversity of citizenship between any of the litigants,¹³² a bankruptcy court technically falls outside the *Klaxon* rule.¹³³

This approach is overly simplistic. As discussed previously,¹³⁴ the Decision Act applies in nondiversity situations. Similarly, the Supreme Court has never held that *Klaxon* applies only in diversity cases.¹³⁵ Therefore, when state law rights are presented to a bankruptcy court in a bankruptcy case, one can make an argument that *Klaxon* should apply. More specifically, to the extent that the justifications underlying the *Klaxon* doctrine apply in a case involving state law rights in the bankruptcy court, *Klaxon* may control the choice of law question in bankruptcy.

A. *The Decision Act Component*

Although the Supreme Court has never ruled on the issue,¹³⁶ the Decision

131. In the opening sentence of *Klaxon*, Justice Reed stated the issue as “whether in *diversity cases* the federal courts must follow conflict of laws rules prevailing in the states in which they sit.” 313 U.S. at 494 (emphasis added). See also *Alcoa Steamship Co. v. Charles Ferran & Co.*, 383 F.2d 46, 56 (5th Cir. 1967), cert. denied, 393 U.S. 836 (1968) (*Klaxon* inapplicable in admiralty litigation).

132. Under the provisions defining the subject matter jurisdiction of the bankruptcy courts, discussed *supra* note 7, the bankruptcy courts may hear disputes related to a bankruptcy case regardless of the citizenship of the litigants. This expansive jurisdiction is much greater than that provided under the Act. Under the Act, the federal courts had bankruptcy jurisdiction only over “summary” proceedings. If an issue was not “summary,” it was a “plenary” issue, which could be adjudicated by the federal courts only if there existed an independent basis for subject matter jurisdiction. Treister, *Bankruptcy Jurisdiction: Is It Too Summary?*, 39 S. CAL. L. REV. 78, 79-80 (1966). In most cases, this meant that a plenary dispute could be litigated in federal court only if there was complete diversity between the litigants.

Diversity courts adjudicating plenary suits generally cited *Klaxon* as controlling the choice of law question. See *Davidge v. White*, 377 F. Supp. 1084, 1088 (S.D.N.Y. 1974); *In re Flying W Airways*, 341 F. Supp. 26, 68 (E.D. Pa. 1972); *Holford v. Leonard*, 355 F. Supp. 261, 263 (W.D. Va. 1973).

133. A few bankruptcy courts have relied on this distinction to declare that *Klaxon* is irrelevant in cases adjudicated under a federal court’s bankruptcy jurisdiction. See, e.g., *In re Crist*, 632 F.2d 1226 (5th Cir. 1980), cert. denied, 451 U.S. 986 (1981); *In re Wallace Lincoln Mercury Co.*, 469 F.2d 396 (5th Cir. 1972) (dictum); *In re Dennis Mitchell Indus., Inc.*, 419 F.2d 349 (3d Cir. 1969); *In re Eli Witt Co.*, 12 Bankr. 757 (Bankr. M.D. Fla. 1981); *In re Duplan Corp.*, 455 F. Supp. 926 (S.D.N.Y. 1978). As discussed above in the text accompanying notes 41-43, the majority of courts do not draw this distinction.

134. See *supra* text accompanying notes 61-67.

135. In *UAW v. Hoosier Cardinal Corp.*, 383 U.S. 696, 705 n.8 (1966), and *D’Oench, Duhme & Co. v. FDIC*, 315 U.S. 447, 456, the Court withheld judgment on the issue of whether *Klaxon* applies in nondiversity cases. See also HART & WECHSLER, *supra* note 49, at 959.

136. See *supra* text accompanying notes 84-92.

Act surely applies to bankruptcy proceedings, at least to the extent that the proceeding involves state law rights.¹³⁷ It follows that those portions of the *Klaxon* rule which rely upon the mandate of the Decision Act should apply equally in bankruptcy. *Klaxon* is highly relevant to the Decision Act question, insofar as it holds that state "substantive" law includes state choice of law rules. Therefore, whenever a bankruptcy court uses state law to decide an issue, it should also look to state choice of law rules to determine which state's law to apply. Unless a bankruptcy court reaches a result consistent with the result that a state court would reach, it is not truly adjudicating state law rights.

B. *Forum Shopping*

The decision in *Klaxon* is based in large part upon the fear of forum shopping. If plaintiffs may affect the outcome of the litigation by their judicious selection of a federal forum or state forum, the plaintiffs would have an advantage not available to plaintiffs in a nondiversity case. In order to avoid this inequity, federal courts must act as state courts with respect to matters likely to result in forum shopping. Because the same threat of forum shopping exists in bankruptcy, it lends support to the theory that the *Klaxon* rule applies in bankruptcy courts.

1. *Forum Shopping in Bankruptcy?*

On first impression, bankruptcy does not seem to present any real opportunities for forum shopping. After all, bankruptcy courts have a much higher entry cost: the filing of a bankruptcy petition and its attendant costs. Debtors filing a Chapter 7 petition must relinquish control of all of their nonexempt assets to a trustee,¹³⁸ and submit, under oath, to interrogation by their creditors.¹³⁹ In this respect, litigating a dispute in the bankruptcy courts differs substantially from litigation in the diversity courts. Litigants in diversity cases are in basically the same situation they would face had they tried the matter in state court.¹⁴⁰

137. The argument that the Decision Act is inapplicable in bankruptcy was stronger prior to its 1948 amendment. Prior to 1948, the Decision Act applied only to actions at common law. Judiciary Act of 1789, § 34, codified as amended at 28 U.S.C. § 725 (1940). In 1948, the Decision Act was amended to cover all "civil actions." See *supra* note 47. Because a bankruptcy proceeding is traditionally considered an action in equity (even though the underlying claim may be a common law claim), Hill, *supra* note 14, at 1020-24, a textual argument existed against application of the Decision Act to bankruptcy prior to the 1948 amendment. Subsequent to the 1948 amendment, this textual argument is not available. A bankruptcy proceeding is clearly a "civil action" within the meaning of the Decision Act.

138. 11 U.S.C. § 541 (1982 & Supp. IV 1986). Although the trustee has the power to exercise control over all of the debtor's assets, including exempt assets, the trustee as a practical matter will normally allow the debtor to claim his exemptions before turning over the remainder.

139. Section 343 of the Code requires a debtor to attend the meeting of the creditors and submit to an examination under oath. 11 U.S.C. § 343 (1982 & Supp. IV 1986).

140. There may be minor differences between state court cases and diversity cases, e.g., respective filing fees or methods of service.

Nevertheless, forum shopping in the bankruptcy courts is a viable option for a significant number of litigants.¹⁴¹ First, bankruptcy does not necessarily wreak havoc upon the financial affairs of debtors. Indeed, if the debtors meet certain requirements, they may qualify for relief under Chapter 13, under which they retain possession and control of most of their prepetition property.¹⁴²

Second, even if debtors must subject themselves to the time and expense of a bankruptcy proceeding, there are incentives to do so. Take, for example, a debtor facing an unliquidated claim for damages. The substantive rules governing the measure of damages may differ significantly in different states. If the claim is of a sufficient magnitude, and if the bankruptcy court would apply a different substantive law to the dispute than would the courts of the state of debtor's residence, the debtor will have an incentive or disincentive to have a bankruptcy court adjudicate the dispute. In this situation, the law chosen by the adjudicating court could have a substantial financial impact on the debtor.¹⁴³ The costs and other sacrifices associated with

141. This is the central theme of the works cited *supra* at note 4. *But cf.* 4A COLLIER ON BANKRUPTCY ¶ 70.07, at 88-89 n.8 (L. King 14th ed. 1976) (arguing that the possibility of forum shopping would not justify a rule which curbed resort to the bankruptcy process).

142. Under section 1306(b), the debtor generally retains control of all property of the estate during the course of the chapter 13 case. 11 U.S.C. § 1306(b) (1982). From a practical standpoint, this is one of the crucial differences between chapters 13 and 7. In chapter 7, all of the debtor's interests in property pass to the trustee upon the filing of the petition. 11 U.S.C. § 542(a) (1982). Unless the property is abandoned back to the debtor under section 554, the debtor will lose all possessory rights in nonexempt property. 11 U.S.C. § 554 (1982 & Supp. IV 1986).

The debtor may also retain control of her property in a case under chapter 11. In chapter 11, the debtor may continue to operate the property as a debtor in possession unless the court appoints a trustee, or an examiner with the right to possess the property. *See* 11 U.S.C. §§ 1104, 1106, 1107 (1982 & Supp. IV 1986).

143. Other attributes of the Code also create incentives to forum shop. For example, a creditor might have a lien in an important piece of the debtor's equipment that is properly perfected under the law of state *A*, but not the law of state *B*. If the debtor can obtain the advantages of the law of state *B* by filing for bankruptcy, the difference in choice of law rules may result in forum shopping.

In essence, the debtor in this situation is using bankruptcy to "preempt" a lawsuit or foreclosure action by the creditor. A bankruptcy court might frown upon this use of the bankruptcy process. Because the debtor is making use of bankruptcy solely to avoid the effect of state law, the bankruptcy court in a chapter 7 case might deem this an "abuse" of bankruptcy, and dismiss the petition under the aegis of 11 U.S.C. § 707(b) (1982 & Supp. IV 1986). If the bankruptcy court can dismiss the case under section 707(b), it could possibly exert some control over forum shopping.

The foregoing situation, however, does not fall under section 707(b). This section was enacted in order to prevent debtors from using chapter 7 in an abusive fashion. It was not designed to deal with the situation in which the debtor's use of bankruptcy itself is abusive. As such, section 707(b) has primarily been applied to debtors who opt for chapter 7 relief even though their anticipated income would be more than sufficient to fund substantial repayment under a chapter 13 plan. *In re Walton*, 866 F.2d 981 (9th Cir. 1989); *In re Kress*, 57 Bankr. 874 (Bankr. D.N.D. 1985); *In re Day*, 77 Bankr. 225 (Bankr. D.N.D. 1987). *See also* Breitowitz, *New Developments in Consumer Bankruptcies: Chapter 7 Dismissal on the Basis of "Substantial Abuse"*, 59 AMER. BANKR. L.J. 327, 344 (1985). *But cf.* *In re Bruno*,

bankruptcy might well be worth the potential savings that would result from the application of the more favorable choice of law rules.

Therefore, forum shopping in bankruptcy is a real possibility. Assuming that state law does govern an issue, a debtor may have an incentive to have a claim adjudicated in a bankruptcy court if there is a significant likelihood of a more favorable result.¹⁴⁴

2. *Why Forum Shopping is Relevant to the Klaxon Rule*

The rule in *Klaxon* is based both upon the Decision Act and the likelihood of forum shopping. Taken together, these elements support a rule requiring federal district courts sitting in diversity to apply the choice of law rules of the forum state. The same logic is also apposite to a degree in bankruptcy. A bankruptcy court can prevent forum shopping between it and the state courts of that forum only if it follows the state court's choice of governing substantive law. Therefore, *Klaxon* arguably dictates the use of forum conflicts rules in bankruptcy proceedings.

Before reaching this conclusion, however, one should examine the effect of the Decision Act and forum shopping on the *Klaxon* rule. Taken alone, the Decision Act does not require a rule as strict as that set out in *Klaxon*. Although the Decision Act requires federal courts to utilize the entire body of state law as the rule of decision, the Act does not mandate that the state law applied be that of the forum.¹⁴⁵ Instead, a federal court could satisfy the constraints of the Decision Act merely by applying the substantive law of any given state, assuming the substantive law was chosen under state choice of law rules.¹⁴⁶ The fundamental purpose of the Decision Act is to

68 Bankr. 101 (Bankr. W.D. Mo. 1986) (debtor convicted of murdering spouse; a bankruptcy filing attempting to discharge loans made by parents and grandparents for bail money and expenses for spouse's funeral held to be an "abuse"). Therefore, section 707(b) will generally be of little use in controlling forum shopping.

144. There are also incentives for a creditor to shop between a bankruptcy court and state courts. The creditor may, of course, force the debtor into bankruptcy by filing an involuntary petition pursuant to 11 U.S.C. § 303 (1982 & Supp. IV 1986). For all practical purposes, however, most creditors will be less disposed to forum shop by forcing the debtor into bankruptcy. First, because of the requirements of section 303, involuntary bankruptcy requires the cooperation of at least one creditor who is not fully secured. Therefore, in the typical situation where the debtor's assets are insufficient to pay all creditors in full, at least one of the filing creditors will not receive full satisfaction of its claim. If the unsecured or undersecured creditor proceeds immediately under state law, however, it may recover a much larger percentage of its claim. Second, unless the debtor has fewer than 12 "creditors" (as limited by section 303), the creditor must locate two others who are willing to force the debtor into bankruptcy court. Third, unlike the case of a voluntary petition, a case involving an involuntary petition may be dismissed upon a showing that the debtor is paying his debts as they become due. See 11 U.S.C. § 303(h)(1) (1982 & Supp. IV 1986). These factors tend to offset any advantage that might exist from the availability of the more favorable law.

145. It has been argued that Congress could render any such rule ineffective by creating district courts with jurisdiction over territory in two or more states. See HART & WECHSLER, *supra* note 49, at 794.

146. The constitutional considerations underlying *Erie* do not support the *Klaxon* rule. See

prevent federal courts from usurping the role of the states by creating a generally applicable federal common law. The Act goes no further. Although expressing a marked preference for state law over federal law, the Decision Act does not require federal courts to look at the laws of any particular state.¹⁴⁷

It is because of the additional consideration of forum shopping that *Klaxon* requires reference to forum choice of law rules. The entire *Erie* doctrine is concerned with "vertical" forum shopping; that is, shopping between the state and federal courts within a given jurisdiction. Once the concern with forum shopping is fused with the requirements of the Decision Act, it becomes important for federal courts to apply *forum* law. *Klaxon* plays an important role in this scheme because it requires federal courts to apply the same substantive law as would a forum court. If a federal court was free to select a substantive law different than that which would be chosen by the courts of the forum, forum shopping would still present a threat.

C. The Considerations of *Klaxon* as Applied to Bankruptcy

The Decision Act is broad enough to cover proceedings in bankruptcy courts. Therefore, bankruptcy courts are obligated to use state law when adjudicating state law claims.¹⁴⁸ As one might expect, this theory reflects current practice in the bankruptcy courts. Even without mentioning the Decision Act, several Supreme Court cases make it clear that bankruptcy courts are to apply state law to determine state-created rights in the absence of a federal statute.¹⁴⁹

Similarly, bankruptcy courts should be required to look at the entire body of state law, including state choice of law rules. This portion of the *Klaxon* rule, stemming from the Decision Act, applies with equal force in bankruptcy. There is nothing unique about the federal process of bankruptcy that authorizes a court to ignore state choice of law rules when considering state law rights. Indeed, a party cannot be said to have a "right" under the law of state *A* unless some court would apply the law of *A* to litigation involving that purported right. The Decision Act therefore requires bankruptcy courts to adopt both state substantive law and state choice of law rules as an integral part of state substantive law.

It is in the realm of forum shopping, however, that the situation in bankruptcy differs. Forum shopping between bankruptcy courts and state

supra text accompanying notes 112-28. Nevertheless, even if the Constitution does apply, it requires no more of the court than to apply state instead of federal law. The constitutional argument does not necessarily imply that the state law be that of the forum.

147. The court cannot be arbitrary in its choice of a substantive law. The due process clause of the fifth amendment sets limits on the federal courts' power to apply the law of a state with no connections whatsoever with the underlying dispute. See *supra* note 127.

148. The case of the bankruptcy remedies presents special concerns. See discussion *infra* at text accompanying notes 179-82.

149. See cases cited *supra* note 15.

courts based on differing choice of law rules is a possibility. The mere possibility of forum shopping, however, does not of necessity mean that forum law applies. Before reaching that conclusion, it is necessary to analyze several important differences between the bankruptcy courts and diversity courts.¹⁵⁰

First, a large number of rights that are adjudicated by a bankruptcy court exist only in bankruptcy. The trustee or debtor in possession has certain rights which only come into being once an involved debtor enters bankruptcy. Under these circumstances, there is no real threat of forum shopping between federal and state courts based upon more favorable choice of law rules.¹⁵¹ Since no state court could hear the claim, it is disingenuous to speak of forum shopping.¹⁵²

150. See, e.g., Note, *Applicability of State Conflicts Rules When Issues of State Law Arise in Federal Question Cases*, 68 HARV. L. REV. 1212, 1218-22 (1955) (although *Klaxon* does not control in bankruptcy, courts may elect to use state conflicts rules based on considerations of "fairness"). The approach suggested by the author is deficient in two respects. First, the Note ambiguously focuses on "claims" instead of "rights." Most of the claims that arise in bankruptcy are federal, because the parties will be litigating the matter in the context of some issue arising under the Code. The applicability of *Klaxon* should turn on more than whether the claim that is the subject of the pending adjudication is a "federal" or "state" law claim. See *supra* text accompanying notes 17-19. Second, the author suggests that the bankruptcy courts should "elect" to use state law absent countervailing considerations. As discussed *supra* at text accompanying notes 90-92, there is no real difference between a rule requiring a court to use state law and stating that the court "normally should" do so.

Most of the other commentators simply reject the *Klaxon* rule without any meaningful discussion. See 4 COLLIER ON BANKRUPTCY ¶ 544.02, at 544-13 through 14 nn. 15 & 16 (L. King 15th ed. 1989) (stating that the "general view" is that state conflict rules do not apply); 4A COLLIER ON BANKRUPTCY ¶ 70.07, at 88-89 n.8 (because there is no need to curb the resort to bankruptcy, the *Klaxon* rule should not apply). See also Countryman, *The Use of State Law in Bankruptcy (Part I)*, 47 N.Y.U. L. REV. 407, 409 (1972) (*Erie* applies only in diversity cases).

151. Obviously, there still may be "forum shopping" of the type discussed *supra* at note 4. In other words, a party may choose bankruptcy precisely because it offers certain rights and remedies which do not exist at state law. This type of forum shopping, which is based on the existence of a federal remedy, does not raise *Klaxon* problems. *Klaxon* represents a limit on the ability of the federal courts to craft choice of law rules. As such, it is irrelevant when Congress has purposely created a federal remedy different from those provided by the states. Accordingly, there is no reason to deter "shopping" between the federal and state court based on the availability of the federal remedy. See *Alcoa Steamship Co. v. Charles Ferron & Co.*, 383 F.2d 46, 56 (5th Cir. 1967), *cert. denied*, 393 U.S. 836 (1968) (*Klaxon* inapplicable in admiralty litigation).

This is not to say that the types of forum shopping that are discussed *supra* at note 4, are irrelevant. These authors are rightly concerned with the issue of "shopping" between bankruptcy and state law in general. This broader type of forum shopping presents a number of additional considerations, and is accordingly beyond the scope of this article.

152. The same argument does not apply to the mixed claims. In one sense, the mixed claims are similar to the bankruptcy remedies, because the same claim involving the same parties could not have been heard by a state court. For example, even though state law might allow unsecured creditors the right to sue to invalidate an improper bulk transfer, the debtor-transferor would have no right to raise this claim under state law. The debtor's right to set aside a fraudulent conveyance will only arise when the debtor dons the hat of a debtor-in-

More importantly, one must consider the different origins of the diversity courts and the bankruptcy courts.¹⁵³ Although the legislative history is sparse, the generally accepted view is that the Constitution allows for diversity jurisdiction in the federal courts¹⁵⁴ in order to prevent local bias against out of state litigants.¹⁵⁵ Congress had the same goal when it elected to vest the

possession by seeking bankruptcy relief.

This difference in parties is not enough to remove the mixed claims from the dictates of the Decision Act. Even though the parties are different, the fundamental claim is the same. The fact that this claim is deemed "assigned" to another under federal law does not transform the claim into a federal claim.

153. There are additional differences between the bankruptcy and diversity courts. These differences, although facially appealing, do not actually distinguish the bankruptcy courts from the diversity courts for the purposes of applying *Erie*. For example, one might argue that the bankruptcy courts are constitutionally compelled to use a federal choice of law rule because of the "uniformity" requirement of article I, section 8 of the Constitution. See U.S. CONST. art. I, § 8. In other words, because any bankruptcy law promulgated by Congress must be uniform, the bankruptcy courts must utilize a single system of choice of law rules to act uniformly. This argument must fail for several reasons.

First, the uniformity requirement is only a restriction on Congress' power to *pass* bankruptcy laws. It is not a restriction on the powers of the federal courts to adjudicate. More importantly, the uniformity restriction has not been interpreted as requiring a uniform federal bankruptcy law. In *Hanover National Bank v. Moyses*, 186 U.S. 181 (1902), the Court held that Congress had not violated this restriction by incorporating state laws into bankruptcy, even though there were important differences in the laws of the states. See also *Baird*, *supra* note 124, at 32 (the "uniformity requirement" simply means that the bankruptcy law must apply in all states).

Another possibly significant difference between the bankruptcy courts and the diversity courts is the enhanced personal jurisdiction of the bankruptcy courts. A bankruptcy court in a forum has the power to bind parties in many situations where the forum courts themselves could not exercise personal jurisdiction. Under Bankruptcy Rule 7004(d), the bankruptcy court can issue nationwide service of process to bring parties into the forum. Diversity courts, however, are bound by the scope of personal jurisdiction that could be exercised by the forum courts. FED. R. CIV. P. 4(e), (f). Therefore, a bankruptcy court in a forum may be able to adjudicate certain claims that could not be adjudicated by a forum court or diversity court. Because the bankruptcy court may hear cases beyond the purview of the forum courts, some authors have argued that *Klaxon* should not apply. See HART & WECHSLER, *supra* note 49, at 799; Note, *supra* note 150, at 1218.

The personal jurisdiction argument is undercut by those cases which apply *Klaxon* even in those diversity cases where the federal court can use extended service. In *Griffin*, the companion case to *Klaxon*, the district court had relied upon the extended service provided by the precursor to 28 U.S.C. § 1335 in statutory interpleader cases. *Griffin v. McCoach*, 313 U.S. 498, 501 (1941). Even though some of the defendants could not have been sued in the courts of the forum, the Court held that the district court was obligated to apply the conflicts rules of the forum. See also *Equitable Life Assurance Soc'y v. McKay*, 837 F.2d 904 (9th Cir. 1988); *Travelers Indem. Co. v. Moore*, 642 F. Supp. 1119 (C.D. Ill. 1986). In addition, *Klaxon* has been applied in a case in which a third party defendant was served pursuant to the "100-mile bulge" provisions of Federal Rule 4(f). *Sprow v. Hartford Ins. Co.*, 594 F.2d 412 (5th Cir. 1979).

154. U.S. CONST. art. III, § 2 provides for diversity jurisdiction.

155. *Guaranty Trust Co. v. York*, 326 U.S. 99 (1945); *Erie R.R. Co. v. Tompkins*, 304 U.S. 64 (1938); *Bank of the United States v. Deveaux*, 9 U.S. (5 Cranch) 61 (1809). See also Hill, *supra* note 113, at 451-52; Ely, *supra* note 104, at 713. But cf. Frank, *Historical Bases of the Federal Judicial System*, 13 LAW & CONTEMP. PROB. 3, 22-28 (1948) (in addition to the

federal district courts with diversity jurisdiction.¹⁵⁶ Diversity jurisdiction controls bias by creating the opportunity for parties to have their claims heard in a neutral forum.¹⁵⁷ The Constitution ensures federal court neutrality by providing a judiciary appointed by the President, with life tenure on good behavior.¹⁵⁸ In short, the primary function of the federal courts sitting in diversity is to provide an alternative to a state court.

In one sense, a bankruptcy court is also an "alternative" to a state court. Were it not for the happenstance of bankruptcy, many of the state-law rights that are before a bankruptcy court would be adjudicated either by a state court or by a diversity court. Most of the state-law rights that parties hold will not be changed by the translation into the bankruptcy system. Like the diversity courts, then, the bankruptcy courts offer an alternative to the state courts.

At this point, however, the analogy ends. Although a bankruptcy court does provide an alternative to a state court action, the justifications for providing the alternative are altogether different. When establishing bankruptcy jurisdiction, Congress' prime concern was not prejudice. Instead, Congress vested the federal courts with jurisdiction over bankruptcy cases and proceedings related to bankruptcy cases primarily for reasons of efficiency.¹⁵⁹ Congress realized that it would be quicker and easier for a court with jurisdiction over the debtor's property¹⁶⁰ to wind up the debtor's affairs if that same court also had the power to resolve all related claims.¹⁶¹

prejudice rationale, the framers desired judges who would be sympathetic to commercial interests and hoped to achieve more efficient administration of justice for the commercial classes); Friendly, *The Historic Basis of Diversity Jurisdiction*, 41 HARV. L. REV. 483, 496-97 (1928) (suggesting that the framers were actually concerned with state insolvency statutes); Stason, *Choice of Law Within the Federal System: Erie Versus Hanna*, 52 CORNELL L.Q. 377, 380 (1967) (another purpose of diversity jurisdiction is to establish "points of contact" between the state and federal systems).

It has also been argued that this fear of "local bias" underlies the other situations in which the district courts are granted concurrent jurisdiction with the state courts. Hill, *supra* note 113, at 452. In other words, the framers mistrusted the state courts with respect to all claims that might be heard in those state courts, regardless of whether the source of the claim is state or federal.

156. See *Hearings on Proposals Concerning Diversity of Citizenship Jurisdiction Before the Senate Subcommittee on Improvement in Judicial Machinery*, 95th Cong., 2d Sess. 521 (1978).

157. Diversity jurisdiction inures to the benefit of both plaintiff and defendant. Although the plaintiff makes the initial determination of whether to file in state or federal court, the nonresident defendant can remove the case to federal court if the case meets the requirements for diversity jurisdiction. 28 U.S.C. § 1441(b) (1982 & Supp. IV 1986). The fact that removal in a diversity case is only available to *nonresident* defendants bolsters the argument that the primary goal of diversity jurisdiction is the prevention of bias. See *infra* note 164.

158. U.S. CONST. art. III, § 1.

159. H.R. REP. NO. 595, 95th Cong., 2d Sess., Pt. I, at 46, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6007.

160. See 28 U.S.C. § 1334(d) (1982 & Supp. IV 1986) (vests district court in which the title 11 case is commenced with exclusive jurisdiction over all property of the debtor).

161. Claims related to a bankruptcy case include both claims against the debtor and claims

Although the *Northern Pipeline*¹⁶² decision had a substantial impact upon this goal of administrative convenience, it nevertheless remains the primary justification for the current jurisdictional scheme in bankruptcy.

A bankruptcy court, then, is an alternative to the entire gamut of non-bankruptcy courts, not merely the courts of a single state. Is this difference significant? From the standpoint of *Klaxon*, it is crucial. The effect of this difference is to change the complexion of the concern with forum shopping underlying *Klaxon*.

Klaxon is concerned with forum shopping between a state court and a diversity court situated within that state. Not all such forum shopping is inherently evil. Indeed, Congress intended to encourage certain types of forum shopping when it provided for diversity jurisdiction.¹⁶³ By providing a neutral forum, Congress encourages nonresidents who fear bias to adjudicate their dispute in a federal forum. This "allowable" forum shopping is directly related to the reasons justifying the very existence of the diversity courts. Forum shopping only becomes evil when it is done for reasons unrelated to the fear of state court bias. When a party elects to use a diversity court because of its advantageous substantive rules, the diversity court is no longer acting merely as a "neutral" alternative to the courts of the forum. Although the law applied by a diversity court may be viewed as "better" from some absolute point of view, it is no longer state law applied by a court insulated from procedural bias.¹⁶⁴

Because the bankruptcy courts were created for reasons unrelated to procedural prejudice,¹⁶⁵ they do not overreach their authority by failing to follow forum law. The bankruptcy courts in state *A* are intended to be an alternative to *all state courts*, not merely the courts of state *A*. Therefore, the fact that parties may have an incentive to pursue their claims in the bankruptcy courts of state *A* rather than in the state courts of state *A* does not necessarily mean that the bankruptcy courts have overstepped their duties. The type of forum shopping underlying the *Klaxon* rule, "federal

by the debtor against other parties. The court must resolve the latter in order to determine what is property of the estate.

162. 487 U.S. at 87-88 n.40.

163. Hill, *supra* note 113, at 451.

164. The Court in *Erie* also expressed some concern that diversity jurisdiction, designed to be a shield preventing discrimination against nonresidents, might be turned into a vehicle for discrimination against residents. *Erie*, 304 U.S. at 74. Although this statement has been criticized, Professor Ely has defended it by noting that the limitations on removal in diversity cases contained in 28 U.S.C. § 1441(b) give the nonresident some ability to have the lawsuit heard in federal court. Ely, *supra* note 104, at 712 n.111.

165. This is not to say that Congress was not concerned with prejudice when creating the bankruptcy courts. Arguably, Congress could have vested the state courts with jurisdiction to hear bankruptcy cases. Congress' failure to do so may indicate some fear that the state courts would be hesitant to afford the broad relief provided by the bankruptcy laws. This "prejudice," however, is based on the substantive rule of law, not on the citizenship of the parties involved. In other words, a pro-creditor state court would be equally biased against a debtor regardless of whether that debtor was a citizen of the state.

court/forum court” shopping, is simply not a concern in bankruptcy.¹⁶⁶ The Code sets out no requirements that bankruptcy courts mirror the courts of the various fora in which they are situated.

Nevertheless, a bankruptcy court does play the role of an “alternative” court. Although not an alternative to an individual state court system, bankruptcy courts are an alternative to the courts of all fifty states. Therefore, a bankruptcy court may exceed its role if it, by using different choice of law rules, creates an incentive for the party to have his rights adjudicated in the bankruptcy court. This broader type of forum shopping creates problems of its own.

However, one does not need to analyze the *Klaxon* line of cases to determine whether this type of forum shopping is acceptable. Instead, one need look no further than the statutory basis for the *Klaxon* rule - the Decision Act. To the extent that the Decision Act affects the choice of law determination, a bankruptcy court may be obligated to look to state law. In essence, we have come full circle.

D. The Decision Act and Bankruptcy

Once one dismisses the forum shopping argument, it becomes apparent that *Klaxon* may not apply in its entirety in bankruptcy. Most importantly, since “federal court/forum court” shopping is no longer a major concern, a bankruptcy court should be under no obligation to adhere to the choice of law rules of the forum state when adjudicating a state law issue. Although a bankruptcy court might be obligated to use state law to govern a dispute,¹⁶⁷ there is no reason why the state law chosen should be the same state’s law that would be applied by the courts of the forum.¹⁶⁸ Accordingly, use of an independent choice of law rule by a bankruptcy court does not thwart the goal of an alternate court system.

This does not mean, however, that state choice of law rules have no application whatsoever in bankruptcy. Many of the rights that a bankruptcy court must adjudicate during the course of a bankruptcy proceeding arise under state law.¹⁶⁹ When the case before a bankruptcy court involves state law rights, the Decision Act still controls. The Decision Act requires a bankruptcy court to use state choice of law rules when interpreting state law rights. This is the essence of the “Decision Act arm” of *Klaxon*, which holds that a federal court must utilize state choice of law rules as part of the state rules of decision. It therefore follows that a bankruptcy court

166. See Hill, *State Procedural Law in Federal Nondiversity Litigation*, 69 HARV. L. REV. 66, 104 (1955), which suggests that forum shopping may be highly desirable in certain types of cases in the federal courts, such as bankruptcy.

167. Nothing in this article suggests that a bankruptcy court adjudicating a pure state claim or mixed claim is free to ignore existing state law altogether.

168. In situations where prejudice against nonresidents is a threat, the alternative federal forum may still be an option. If the out-of-state litigant desires a “neutral” forum, she can still bring the lawsuit in a federal district court if she can satisfy the requirements for diversity jurisdiction.

169. See *supra* text accompanying notes 14-16.

cannot reach a result inconsistent with the result that *all* state courts that could hear the claim would reach. Accordingly, a bankruptcy court must pay some heed to state choice of law rules.

There is a fundamental difference between the reference to state law required in bankruptcy and the adherence to forum law mandated by *Klaxon*. All the Decision Act requires is that the bankruptcy court not ignore state law. The bankruptcy court must look to state law, including state choice of law rules, for the parameters of the parties' rights. Nothing in the Decision Act indicates, however, that the state law chosen be the law of the forum. Instead, a bankruptcy court need only apply the law of some state in order to adjudicate the parties' state law rights.

On the other hand, a bankruptcy court must ensure that the result in bankruptcy does not differ substantially from the result that would have been obtained in the absence of bankruptcy. Although not bound by the law of any single forum, a bankruptcy court is not free to utilize rules of decision that would not be used by *any* eligible state court. If a bankruptcy court ignored all state law, it would exceed its role as an "alternative" to the entire set of state courts. This places a significant restriction on the freedom to select which state's laws should govern. At the very least, the result reached in a bankruptcy court should mirror the result that would have been attained by some state court.

E. Application of the Rule to Specific Types of Claims

The foregoing discussion indicates that the choice of law issue in bankruptcy cannot be divorced totally from state choice of law rules. If bankruptcy courts were free to create their own choice of law rules, they would be free to apply substantive law that would not be applied by any non-bankruptcy court that might have heard the case. Unless the result in bankruptcy could have been reached by at least one competent nonbankruptcy court, a bankruptcy court is not really adjudicating a state law right.

1. Pure and Mixed Rights

The foregoing analysis clearly applies to the "pure" and modified state law claims discussed previously.¹⁷⁰ In these situations, the underlying dispute is one that would have been heard in a state court or diversity court absent bankruptcy.¹⁷¹ Because a bankruptcy court is adjudicating state law rights in the context of a state law claim, the Decision Act indicates that the substantive law applied by a bankruptcy court should not differ from that applied in the state courts.

170. See *supra* text accompanying notes 24-29.

171. The transplantation of the state law claim into bankruptcy may give rise to additional issues that would not be a factor in the state court proceeding. An obvious example is where the trustee is attempting to recover damages for a lease containing a clause setting forth certain modifications which automatically come into force upon bankruptcy. Section 365 renders these clauses ineffective. See 11 U.S.C. § 365 (1982 & Supp. IV 1986). Although the suit in the bankruptcy court now involves additional nonstate law issues, the dispute remains fundamentally a state law breach of contract claim.

At a minimum, then, a bankruptcy court should be limited in its selection of state law to a state law that would be chosen by some state court. This does not mean that a bankruptcy court must analyze the conflicts rules of each of the fifty states on every claim it faces. Instead, a bankruptcy court must determine which state courts would have the power to adjudicate the dispute outside of bankruptcy. Once this is completed, a bankruptcy court must choose from among the available fora's laws the law which is to govern the dispute.

The first task of a bankruptcy court, then, is to prepare a list of courts that could hear the claim.¹⁷² This requires a court to determine which state courts have personal jurisdiction over the defendants¹⁷³ and in which state courts venue properly lies.¹⁷⁴ Unless the debtor or creditor is a large multistate corporation, the list of available fora should be relatively short.¹⁷⁵

172. In many cases, the courts of foreign countries might also be able to hear a case. Where the law of the foreign courts (including the conflicts rules) is available, the bankruptcy court should also include the foreign courts in its list. A cause of action arising under the law of a foreign country is, for all practical purposes, indistinguishable from a "state law" claim normally adjudicated by the bankruptcy court. The underlying rights will still be created by nonbankruptcy law.

It should be noted that the bankruptcy court adjudicating a foreign law claim is not *required* to use the foreign choice of law rules. The Decision Act does not apply when foreign law is involved. Nevertheless, when the foreign law is ascertainable, the court should use it to govern all rights arising under foreign law. By so doing, the court will act in accordance with the reasonable expectations of the parties.

173. In making this determination, the court should also consider the possibility of a "preemptive" suit by a debtor against a creditor. For example, a debtor may be able to select a forum by bringing a declaratory judgment action against a creditor. In this situation, the important issue would be personal jurisdiction over the creditor, not the debtor.

Of course, it is theoretically possible that a defendant could be subjected to suit in any state, district, or territory in the United States. As stated in the watershed case of *Pennoyer v. Neff*, 95 U.S. 714 (1877), a defendant is subject to suit in any forum in which that defendant is served while physically present, even if that defendant is merely passing through the state. Cf. *Humphrey v. Langford*, 246 Ga. 732, 273 S.E.2d 22 (1980) (defendant's only connection with the adjudicating forum was his physical presence).

The continuing validity of this type of "transient" jurisdiction is open to question, however, following the Supreme Court's decisions in *World-Wide Volkswagen Corp. v. Woodson*, 444 U.S. 286 (1980), which emphasizes the foreseeability to the defendant of being called upon to litigate the matter in the forum, and *Shaffner v. Heitner*, 433 U.S. 186 (1977), which holds that all assertions of jurisdiction are to be measured by the "minimum contacts" standard. Nevertheless, the possibility of "transient" jurisdiction could render the proffered analysis meaningless. Because it might be possible to obtain "transient" jurisdiction over a party anywhere in the United States, the bankruptcy court arguably could apply the conflicts rule of any state or territory that it chose.

For the purposes of this analysis, a bankruptcy court should ignore those states in which personal jurisdiction could be obtained only by these "transient" means. Instead, the court should focus on those states in which personal jurisdiction could actually have been procured in a nonbankruptcy action commenced on the date of the bankruptcy petition. The only possible exception would be the case where it could be demonstrated that the potential defendant was actually present, on the date of the bankruptcy petition, in a state with which he had less than the required "minimum contacts."

174. A more complicated situation arises when the action could have been heard in a diversity court. In this case, the court must consider both state and federal personal jurisdiction

Following the compilation of this list, a bankruptcy court should look at the conflicts rules of each of the available fora to determine which states' substantive laws could be applied to the lawsuit. The resulting list will indicate those states which would provide a "cause of action" for the given transaction or occurrence. In most instances, this list should be even more abbreviated than the first, because of the similarity in factors considered by most states in their choice of law rules.¹⁷⁶

At this point, a bankruptcy court should select one "rule of decision" from the list of available laws. In making this decision, however, a bankruptcy court should no longer be bound by any of the requirements of state law. In other words, once a bankruptcy court has determined that at least one available state court would apply the law of state *A* to a cause of action, the bankruptcy court may, consistent with the Decision Act and the purposes of bankruptcy, choose that set of rules as controlling.¹⁷⁷ The final

and venue rules. Because nothing in *Erie* requires the diversity court to follow state venue rules, *Stewart Org. v. Ricoh*, 108 S. Ct. 2239 (1988), a diversity court may, in certain rare cases, hear an action that could not be heard in the courts of the forum. Therefore, a state's choice of law rules need not be excluded from the calculus merely because its state courts would not be a proper venue to adjudicate the dispute. If the case is one that could have been heard in a diversity court in that state, the bankruptcy court should also consider that state's choice of law rules, because a diversity court sitting in that state would be required to do so.

175. In some instances, it is conceivable that *no* state court would be able to adjudicate the dispute. This is most likely to arise when no state court could exercise jurisdiction over the defendants in the dispute. Naturally, in such cases the bankruptcy court will be unable to mimic the outcome in state court. Instead, the bankruptcy court must necessarily engage in an independent determination of the choice of law problems, *i.e.*, apply "federal" choice of law rules.

The foregoing situation does not create an anomaly. When no state court could have adjudicated the dispute, the bankruptcy court does not run afoul of the Decision Act by refusing to follow state choice of law rules. A party has a right to expect the application of the choice of law rules of state *A* only if the courts of *A* would have jurisdiction to hear the dispute.

176. The author of Note, *supra* note 150, at 1219, rejects this approach as too difficult. This concern is somewhat exaggerated. First, unless the potential defendant is a large commercial entity, it will be subject to suit in only a very few states. Second, and more importantly, nothing requires the bankruptcy court to analyze each and every state's conflicts rules. Instead, as a practical matter, the bankruptcy court need only use this analysis as a means of "checking up" on its choice of substantive law.

In other words, the bankruptcy court, using general conflicts principles, may decide that the transaction bears the greatest number of contacts with state *D*, so that the law of *D* should govern. Before applying the law of *D*, however, the bankruptcy court should ensure that some other state that could have heard the lawsuit (not necessarily *D*) would also apply the law of *D*. If at least one potential forum would choose the law of *D*, the bankruptcy court is accurately adjudicating a state law claim. If no viable state court would choose the law of *D*, the bankruptcy court would be ignoring state law were it to determine the rights of the parties in accordance with the law of *D*.

177. This result is fully consistent with the criteria set out by those authors cited *supra* at note 4. These authors state that bankruptcy courts should follow state law in order not to frustrate the commercial expectations of the parties. *See, e.g.*, Eisenberg, *supra* note 4, at 957. The law that will be selected by the bankruptcy court using the above approach will be one

choice of controlling law from among the available candidates is purely a federal matter.¹⁷⁸ Once state law creates the list of options, a bankruptcy court need not consult state law in determining which state has the greatest connection to the transaction. As long as some state would apply the substantive law ultimately chosen by the bankruptcy court, the court has fulfilled its obligation to define the rights of the parties in accordance with state law. Nothing in the Constitution, the Decision Act or the Code requires anything more.

2. *The Special Case of Bankruptcy Remedies*

That category of cases comprising the bankruptcy remedies poses a more difficult problem. As described previously, a proceeding involving a bankruptcy remedy is one in which the fundamental rights being adjudicated are created by the Code. Although the fundamental claim is federal, it cannot be resolved without interpreting state law. It is the federal nature of the remedy that makes the bankruptcy remedy a special situation. Unlike the state law remedies previously discussed, the claim is not one which would have been heard in a state court absent bankruptcy.¹⁷⁹ The right to recovery does not even arise until the debtor enters bankruptcy.

that should have been foreseen by the parties. Unless the selected conflict rules are markedly inconsistent with general choice of law principles, the state whose substantive law is eventually chosen will have considerable contacts with the underlying transaction. Indeed, unlike the diversity courts under *Klaxon*, the bankruptcy courts would have the ability to ignore grossly unfair conflicts rules simply by adopting the law that would be chosen by a different available state. Therefore, failing to utilize *Klaxon* in its entirety may actually result in *less* surprise and unfairness of bankruptcy than would a mechanical application of the rule.

In addition, the fact that the bankruptcy court must consider personal jurisdiction furthers the foreseeability factor. Because of the due process limitations on personal jurisdiction of the state courts, a state may assert personal jurisdiction over a party only if that party could reasonably foresee being haled into the forum. *World-Wide Volkswagen Corp. v. Woodson*, 444 U.S. 286, 295 (1980).

178. In making this determination, the bankruptcy court should have considerable discretion in selecting which substantive law to apply. Over time, this should generate a "federal" law of choice of law for use in the bankruptcy courts. There is nothing incompatible between this result and *Erie*. The federal court is reaching a result consistent with the result that would be reached by a state court. Therefore, the bankruptcy court is not creating a new federal substantive law to govern the rights of the parties. The bankruptcy court is adjudicating state law rights, albeit not necessarily in the form that those rights would be adjudicated in a *forum* court.

179. It is possible, though unlikely, that a state court could adjudicate a bankruptcy remedy. Although 28 U.S.C. § 1334 (1982 & Supp. IV 1986), provides the federal district courts with original and exclusive jurisdiction over the bankruptcy case itself and exclusive jurisdiction over all of the debtor's property, the district courts share jurisdiction with the state courts over all disputes arising during the course of the bankruptcy case. Conceivably, then, a state court could adjudicate a bankruptcy remedy if the bankruptcy court chose to abstain under 11 U.S.C. § 305 (1982), or 28 U.S.C. § 1334(c) (1982 & Supp. IV 1986). It is difficult to imagine, however, a situation involving a bankruptcy remedy in which the district court would choose to abstain.

Because of this difference, one can argue that a bankruptcy court adjudicating a bankruptcy remedy should have the freedom to ignore state choice of law rules altogether. Because the right arises under federal law, there may be no compelling reason for a bankruptcy court to mimic the state courts.¹⁸⁰ Indeed, if one focuses on the origin of the claim, it is disingenuous to speak of mimicking a state court. Where a state court would never hear the claim, there is nothing to copy.

This argument focuses its analysis on the wrong level. It is true that a state court could not hear a bankruptcy proceeding. However, a state court could adjudicate the state law rights presented in the course of resolving the federal bankruptcy remedy.¹⁸¹ To adjudicate these state law rights accurately, a bankruptcy court must not divorce itself totally from state choice of law rules. If it does, a bankruptcy court may face a situation in which the identical state law right appears more than once in a case, but is interpreted differently depending on the context in which it is presented.¹⁸² By creating this inconsistency, a bankruptcy court transforms a state law right into one not recognized by the courts of those states that created the right. At this point, the basic right becomes a federal law right instead of a state law right.

Therefore, a bankruptcy court should also be bound by state choice of law rules in cases involving bankruptcy remedies. To the extent that a bankruptcy remedy relies on preexisting state law rights, a court should look to state choice of law rules in order to ensure consistent adjudication. A claim's federal origin should not authorize a bankruptcy court to ignore state choice of law rules. Accordingly, the choice of law analysis for bankruptcy remedies is no different than that for the more common state law claims. Because state law rights are involved, a court must look initially to state choice of law rules.

V. Conclusion

Bankruptcy presents a number of special circumstances that complicate the choice of law issue. Unlike a federal district court adjudicating a federal question, a bankruptcy court faces many issues of state law. In liquidating the estate of a debtor, a bankruptcy court will be required to resolve a

180. See, e.g., Note, *supra* note 150, at 1220-21.

181. These state law issues could become important in the context of adjudicating a state law claim arising out of the same facts. For example, the bankruptcy remedy of a preference may require the court to determine, inter alia, whether the creditor has perfected its security interest. That same issue would also be crucial in a state law priority battle.

182. Utilization of different choice of law rules for "federal" and "state" claims could result in unnecessarily complex problems of res judicata and collateral estoppel. For example, assume that one of the debtor's creditors is an attorney. The law of state *A* recognizes attorney's liens; whereas the law of state *B* does not. This state law lien right will be relevant both to state law claims (e.g., the attorney's right to foreclose) and to a bankruptcy remedy (e.g., whether a payment to the attorney is voidable as a preference under section 547 of the Code). Therefore, it follows that the courts should strive for consistent interpretation of the basic state law right.

number of state law claims by and against the debtor. Because a bankruptcy court adjudicates state law claims, issues of federalism arise that are not present in the typical federal question case.

A bankruptcy court also differs in many respects from a diversity court. The state law claims faced by a bankruptcy court are adjudicated in the context of a uniquely federal insolvency proceeding. In addition, bankruptcy courts were created for reasons different from those underlying the creation of diversity courts. Unlike bankruptcy courts, diversity courts were intended to deter prejudice against out of state litigants.

Bankruptcy courts, then, lie in the “gray area” between diversity courts and courts hearing federal question cases. Therefore, it is not surprising that the effect of state choice of law rules should also lie somewhere in the middle. Because a bankruptcy court has a different purpose than a diversity court, the *Klaxon* rule does not apply in full. Generally, *Klaxon* does not require a bankruptcy court to adhere to forum choice of law rules.¹⁸³ Instead, only that arm of the *Klaxon* rule requiring reference to state choice of law rules applies in bankruptcy. A bankruptcy court, to satisfy the requirements of the Decision Act, must use the same substantive law that some state court of competent jurisdiction would have used.

The proffered rules strike a balance between the federalism issues that are ever present in bankruptcy and the legitimate federal concern for an efficient bankruptcy system. Although a bankruptcy court is not free to ignore state substantive law, it should have a great deal more latitude in dealing with state choice of law rules. As long as a bankruptcy court affords proper respect to the important role that state law plays in bankruptcy, it satisfies the requirements of both the Constitution and the Decision Act.

183. The bankruptcy court will be required to look to forum laws only in those instances in which the choice of law rules of *all* available states would result in the use of forum law. In a case involving an individual debtor, this situation will be uncommon.